

ANALYSIS
OF FISCAL
POLICY IN SPAIN:
A MACROECONOMIC
PERSPECTIVE

(1988-1994)

Ángel Luis Gómez Jiménez
and José María Roldán Alegre

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INTRODUCTION (1)

Fiscal policy, in both its macroeconomic and microeconomic strands (the former concerning the control of the level and composition of demand, the latter the impact of the tax system, of the level and structure of government consumption, and of infrastructure, etc. on economic agents' consumption and investment decisions), is destined to have an increasingly greater influence over economic activity. Several factors explain this relevance of fiscal policy. On one hand, the policies regulating private agents' economic activity are structural and, therefore, discontinuous. As the structural reforms to liberalise markets (including most notably the labour market) and standardise regulations in the EU economic space are progressively completed, national authorities will, in a fully liberalised setting, see their scope increasingly curtailed, and the use of such policies by national authorities in their economies as discretionary intervention instruments will be increasingly less possible. As to incomes policies, these lack the versatility and flexibility necessary for use in the very short term, not to mention the major difficulties that reaching agreements in an increasingly diversified and flexible economy entails. Such an incomes policy is seen as an exceptional instrument lacking the sufficient flexibility to enable its continued use in the short term. Against this background, fiscal policy, along with monetary policy, assumes a leading role as a macroeconomic policy instrument for the coming years. However, two factors also curtail the margin for manoeuvre of fiscal policy. First, the expansionary and pro-cyclical nature of fiscal policy in the previous boom ensued in a considerable increase in the structural general government budget deficit, leading subsequently in the latest recession to high budget-deficit and outstanding-public-debt levels. Given the deterioration there has been, the short-term fiscal policy priority can be no other than budgetary consolidation and the stabilisation of the public debt/GDP ratio. Second, the transition to Monetary Union – the conditioning factors of

(1) We gratefully acknowledge the suggestions and comments by Isabel Argimón, José María Bonilla, José Manuel González-Páramo, José Marín and Francisco Martí on preliminary versions of this work.

which are detailed in the Maastricht Treaty – makes the need for fiscal consolidation even more pressing, so that one of the criteria governing entry into the Union may be met. This is the excessive fiscal deficit criterion whereunder, broadly speaking, public debt and the general government budget deficit may not exceed 60 % and 3 % of GDP, respectively (2).

These conditioning factors are placed in sharper relief if regard is had to the fact that the budgetary imbalance in 1994 was moderate, in view of the heavy deterioration in public finances in 1993 and considering that the pick-up in economic activity was greater than expected. The design of fiscal policy according to the 1995 Budget and the initial budget outturn data for the year also point to a limited reduction in the deficit. All these factors accentuate the need to accelerate the fiscal consolidation process embarked upon in 1994.

This work makes a detailed analysis of the fiscal policy pursued from 1988 to 1994 and its possible contribution to the process of convergence towards Monetary Union. Chapter I outlines fiscal policy from a macroeconomic perspective, focusing on developments in the various revenue and expenditure captions. By means of the use of discretionary action indicators, the fiscal policy stance in the period spanning 1988 to 1994 is then characterised in Chapter II. Chapter III examines the macroeconomic impact of fiscal policy, specifically on inflation, the external deficit and economic agents' uncertainty. In Chapter IV a study is made of the fiscal policy perspective with a view to Monetary Union. Lastly, in Chapter V, the main conclusions are drawn. Two appendices complete the work, the first detailing the budgetary policy measures adopted in the period 1988-1995, and the second describing the methods of computing the discretionary action of fiscal policy.

(2) Several factors need to be taken into account to judge the fiscal deficit as "excessive". These include the economy's cyclical position, the exceptional nature of the deviation, the fall in the debt ratio at a continuous and sufficient rate, the fact that public investment should be greater than the deficit, etc. In any event, these complementary factors are defined with a considerable degree of ambiguity.

I

BASIC FEATURES OF FISCAL POLICY IN THE PERIOD 1988-1994

Fiscal policy affects all areas of activity engaged in by economic agents, whether these are consumers, employees or employers. Incentives and potential distortions wielding a powerful influence on the level of economic activity, the sectoral productive structure, and the growth and composition of aggregate demand are generated by a series of factors. These include most notably the design of the tax system (both overall and in terms of each particular tax); the composition of government consumption (its degree of substitutability or complementarity in relation to private consumption); the degree of income redistribution introduced by government action; the implementation of regulations governing social and economic activity; and the degree of effective protection vis-à-vis the external sector (via tariffs, import quotas or specific regulations, etc.). A detailed analysis of the effects of fiscal policy is thus a task beyond the scope of this work.

The present chapter solely analyses fiscal policy in its macroeconomic policy facet. It studies the major public revenue and spending aggregates, and the potential impact that the level and composition of such aggregates, coupled with the resulting general government budget deficit, have had on the business cycle. In particular, it focuses on the effects of fiscal policy design on the economic policy mix.

I.1. Fiscal policy before 1988

Historically, State intervention in economic activity was based on regulatory norms rather than on budgetary measures. It was only after the mid-seventies that general government spending grew; indeed, its weight in terms of GDP doubled in the period from 1975 to 1985. This was the

result of an approximation to European standards of social welfare that commenced with the restoration of democracy. This long-term tendency was reinforced by the economic crisis in the second half of the seventies, which led to an increase in transfer payments to households and firms so as to alleviate the impact of the crisis. The twin pressures on public spending – one structural the other cyclical – were not sufficiently offset by the increase in public revenue, despite the favourable tax-raising results stemming from the 1977-78 fiscal reform. These changes in the fiscal policy environment entailed a strong increase in the general government budget deficit, which rose to 6.9 % of GDP in 1985.

In parallel to this widening of the budget shortfall, partial progress was recorded in the management of public finances. In particular, as from 1982, the monetisation of the budget deficit was progressively reduced and a more orthodox means of funding was adopted. That provided for an increase in the degree of autonomy – and efficiency – of monetary policy, although other financial distortions arising from the introduction of compulsory ratios for credit institutions were caused. Nonetheless, this more orthodox financing of the deficit had an adverse impact in the short term, since the increase in the interest burden more than countered the efforts to contain public spending and the increase in tax revenue.

A considerable fiscal consolidation drive was undertaken in 1986 and 1987. As a result, the overall general government budget deficit in 1987 stood at 3.1 % of GDP, i.e. 3.8 percentage points down on two years previously. Although such progress was notable, it came about mainly due to increases in revenue (2.1 percentage points of GDP between 1985 and 1987) rather than to the containment of expenditure (which declined even so by 1.7 percentage points of GDP between 1985 and 1987). The nature of these budgetary dynamics, the difficulty in containing the growth of spending and the dependence on the strength of revenue to correct the budget imbalance were at the root of the difficulties that would arise in the following phase of economic slowdown.

Despite the advances made, the substantive problems behind the increase in the budget imbalance persisted. There was continuing pressure on spending resulting from the setting in place of an increasingly broader welfare state, along the lines of the wealthiest European countries. At the same time, the pursuance of administrative decentralisation, associated with the consolidation of the “State of Autonomies” (the devolution of powers to regional governments), entailed a sustained increase in government consumption. Adding to this was an ambitious public investment programme, which sought to remedy in a very short time the deficiencies built up in past decades. On the revenue side, the strong increases in tax takings further to the 1977-78 fiscal reform (which set a modern direct taxation system in place) and the introduction of VAT in 1986 provided for

intense and rapid growth in the tax burden. This could not continue in the future, inasmuch as the Spanish tax system was now fully in line with the European norm. Only the improvements in tax administration and in combating fraud, the process of EU harmonisation and of indirect taxation levels and the positive impact of the cycle on tax revenue would offer any margin for increasing the tax burden. And then such an increase could not be equated to the structural leap forward attained with the establishment in Spain of a modern tax system.

The firmly embedded upward trend of spending as a percentage of GDP and the gradual tapering off of the margin for manoeuvre available on the revenue side shaped a complex situation which, nonetheless, appeared to be circumvented by the rapid growth experienced by the Spanish economy. In the following years, and as the favourable contribution of the cycle progressively dwindled, the substantive problems at the root of the budgetary imbalance in the first half of the eighties resurfaced. Adding to this, lastly, was a process of expenditure decentralisation, pursuant to the implementation of the so-called State of Autonomies. This implementation would give rise to fresh pressures on the deficit – namely, the great weight of State transfers and the lack of “fiscal co-responsibility” introduced thereby – due both to the tendency towards expenditure duplication this generated and to the distortions arising from the financing structure for these new territorial entities.

I.2. The period 1988-1994

1988 marked a turning point in the public finances imbalance. Firstly, the business cycle showed the first signs of petering out; although the year was still one of forceful expansion (GDP grew by 5.2 % in real terms), the first symptoms of a slowdown in economic activity became perceptible. Further, the fiscal containment drive embarked upon in 1985 finalised that year, which was partly concealed by the contribution of the cyclical upturn to the moderation of public spending and to tax revenue persistence. Lastly, the economic boom and the success in checking the budget deficit in 1986 and 1987 intensified the pressures on public spending, specifically on that aimed at extending welfare coverage. The culminating point of such pressures was the December 1988 general strike. This unequivocally governed fiscal policy in subsequent years, and is one of the factors that explains the grind to a halt (and later backtracking) in the fiscal consolidation attained in the previous period.

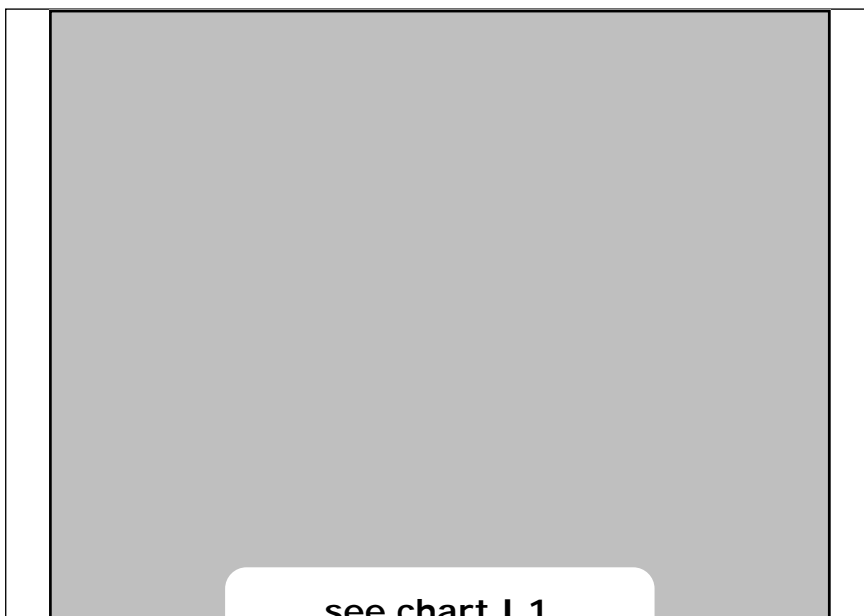
As Table I.1 and Chart I.1 reveal, the reduction of the budget deficit tailed off after 1988, stabilising at somewhat over 3 % of GDP between 1987 and 1990. In effect, the apparent decline in 1989 was the conse-

quence of transferring to 1990 the refunds relating to excess personal income tax paid in 1988, for an estimated volume of PTA 323 billion (equivalent to about 0.7 percentage points of GDP). After 1990, the budget deficit began to widen, moving from 4.1 % in 1990 to 4.9 % in 1991, 4.2 % in 1992 (the result in part of a new transfer of personal income tax refunds from 1992 to 1993 for a net volume of PTA 195 billion, 0.3 percentage points of GDP) and 7.5 % in 1993. A moderate reduction in the deficit began in 1994, placing it at 6.7 % of GDP. Examination of the primary deficit – i.e. the budget deficit less interest actually paid – reveals a similar pattern to the total budget deficit (Chart I.2): the primary deficit, after holding stable at marginally negative values, began to widen as from 1990, a process only interrupted in 1992, rising after a sharp leap to 2.2 % of GDP in 1993, and dipping to 1.4 % in 1994.

Regarding public debt (Chart I.3) it should be noted that, despite (i) the stabilising of the deficit in terms of GDP at the end of the eighties; (ii) the relative increase in the financial cost of debt (due to a more orthodox financing of the deficit); and (iii) the taking over of liabilities from public-sector enterprises, the ratio of public debt to GDP not only did not increase in the initial years but even fell from 45.5 % in 1987 to 41.7 % in 1988, rising to 45.8 % in 1991. The relative moderation of the public debt/GDP ratio, the result of the strength of GDP growth (which grew on average in nominal terms by 11 % between 1988 and 1991) (1), came to an end in 1992. That year, the recession manifested itself with greater intensity (real GDP growth was only 0.7 %, 7.5 % in nominal terms), and the debt/GDP ratio increased by almost three percentage points to 48.4 %. In 1993 the debt/GDP ratio climbed 12 points, due both to the widening of the budget deficit and to the decline in GDP growth (Chart I.4). The ceiling of 60 % of GDP, agreed under the Maastricht Treaty as one of the convergence conditions for entry into the last stage of European Monetary Union, was thus overstepped. Despite the pick-up in the rate of economic growth and the slight reduction in the primary deficit in 1994, the debt/GDP ratio still increased by 2.6 percentage points that year. That evidences the difficulty of stabilising this ratio at times, such as the present, when public finances are heavily in disequilibrium.

On analysing the breakdown of the budget deficit into revenue and expenditure, the key feature that emerges is the simultaneous increase in the weight of both in relation to GDP. Expenditure increased from 41.1 % in 1988 to 48.2 % in 1994. This surge may be attributable, but only in part, to the effect of the recession: between 1988 and 1991, the jump totalled 4.2 points of GDP, despite the economic expansion in those years (real growth of 5.2 % in 1988, falling to 2.2 % in 1991). Revenue in-

(1) The heavy fall in 1988 is attributable, however, to a change in the accounting for relations between the ICO (Official Credit Institute) and the State.

PUBLIC REVENUE AND EXPENDITURE

Sources: Ministerio de Economía y Hacienda and Banco de España.

creased by 3.8 percentage points of GDP between 1988 and 1994 as a result of the advance of tax revenue, which rose by 2.7 points of GDP, and of transfers and other revenue, which climbed by 1.1 points of GDP. Of particular note was the slide in tax revenue in 1993, due to the effect of the recession and to the changes in tax management. Though partly offset in 1994, this placed the share of revenue in GDP in 1994 at 0.6 points below that of 1992.

This distinctive feature of Spanish public finances (the widening of the budget deficit as a result of growth in expenditure that cannot be offset by the simultaneous expansion of public revenue) runs counter to the experience of the main EU countries. In the latter, the rise in the budget deficit originates in tax reforms entailing a reduction in the tax burden. In Spain, although certain tax measures entailing forgone revenue came about (such as the new personal income tax arrangements that came into force in 1992), these were more than offset with other measures increasing taxes. In short, it is the upward-trending dynamics of public spending, associated only in part with the impact of the economic crisis, that underlies the widening of the budget deficit between 1988 and 1994: whereas the average nominal growth of GDP was 8.7 % during these years, that of public spending was 11.3 %.

**GENERAL GOVERNMENT: INCOME, USE OF INCOME AND CAPITAL ACCOUNTS
% of GDP**

	1987	1988	1989	1990	1991	1992	1993	1994
Current revenue	37.4	37.3	39.1	38.9	39.6	41.3	41.2	40.6
Taxes linked to production and imports	10.4	10.4	10.3	9.9	9.8	10.2	9.6	10.2
Taxes on income and net worth	10.3	10.4	12.1	12.0	12.0	12.4	11.9	11.4
Social security contributions	12.8	12.5	12.8	13.0	13.2	14.0	14.3	14.4
Other income	3.9	3.9	3.9	3.9	4.5	4.6	5.5	4.6
Current transfers paid	20.7	20.8	21.0	21.6	22.7	23.7	26.1	25.9
Welfare benefits	13.8	13.9	13.9	14.4	15.2	16.1	17.0	16.7
Subsidies	1.8	2.1	2.0	1.9	1.8	1.7	2.0	2.0
Actual interest payments	3.5	3.4	3.5	3.7	3.9	4.2	5.2	5.3
Other current transfers	1.6	1.5	1.6	1.5	1.7	1.6	1.9	2.0
Gross disposable income	16.8	16.5	18.1	17.3	16.9	17.6	15.1	14.7
Government consumption	15.1	14.8	15.2	15.6	16.2	17.0	17.5	17.0
Compensation of employees	10.4	10.5	10.7	11.1	11.5	12.2	12.3	11.9
Net purchases of goods and services	3.7	3.3	3.5	3.5	3.6	3.7	4.1	4.0
Consumption of fixed capital	1.0	1.0	1.0	1.0	1.0	1.0	1.1	1.1
Gross saving	1.7	1.8	2.9	1.8	0.8	0.6	-2.4	-2.3
Capital revenue	0.4	0.6	0.7	0.6	0.8	0.8	0.9	1.0
Capital taxes	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.3
Capital transfers	0.2	0.3	0.5	0.4	0.6	0.6	0.7	0.7
Public investment	3.4	3.8	4.4	5.0	4.9	4.2	4.2	3.9
Gross fixed capital formation	3.3	3.7	4.4	4.9	4.8	4.1	4.1	3.8
Net purchases of land	0.2	0.2	0.1	0.2	0.1	0.1	0.1	0.1
Capital transfers paid	1.8	1.7	1.9	1.5	1.5	1.4	1.8	1.5
Net lending (+) or net borrowing (-)	-3.1	-3.3	-2.8	-4.1	-4.9	-4.2	-7.5	-6.7
MEMORANDUM ITEMS:								
Primary deficit	-0.3	-0.1	-0.7	0.4	1.0	-0.0	2.2	1.4
Total revenue	37.8	37.8	39.8	39.6	40.4	42.1	42.1	41.6
Tax revenue	33.7	33.6	35.4	35.2	35.3	36.9	36.0	36.3
Total expenditure	41.0	41.1	42.6	43.7	45.3	46.3	49.6	48.2
Final demand	18.5	18.6	19.6	20.6	21.1	21.2	21.7	20.9
Net transfers	18.3	18.2	18.6	18.7	19.1	19.9	21.8	22.1
State net lending (+) or net borrowing (-)	-3.5	-3.0	-2.2	-2.9	-2.3	-2.3	-6.1	-5.1

Sources: Ministerio de Economía y Hacienda and Banco de España.

TABLE I.1

GENERAL GOVERNMENT: INCOME, USE OF INCOME AND CAPITAL ACCOUNTS (continuation)
Rate of change

	1988	1989	1990	1991	1992	1993	1994
Current revenue	10.7	17.6	10.8	11.5	12.0	3.1	4.6
Taxes linked to production and imports	10.3	11.9	6.8	8.5	11.4	-3.0	12.5
Taxes on income and net worth	13.3	29.4	10.8	9.7	10.9	-1.0	2.0
Social security contributions	8.9	14.6	13.5	11.0	14.2	4.8	7.1
Other income	10.7	11.1	12.9	25.5	9.9	21.8	-10.2
Current transfers paid	11.5	13.6	14.2	15.2	12.2	14.0	5.2
Welfare benefits	11.6	12.7	15.0	15.9	13.8	8.5	4.3
Subsidies	26.8	7.2	8.1	3.3	1.5	22.3	2.5
Actual interest payments	7.2	15.9	19.6	15.7	14.8	29.0	7.0
Other current transfers	3.5	25.2	3.0	21.8	2.4	21.2	11.4
Gross disposable income	9.6	22.7	6.9	6.8	11.8	-11.7	3.6
Government consumption	8.7	15.3	14.4	13.7	12.9	6.4	3.0
Compensation of employees	11.9	14.5	15.8	13.5	14.1	3.6	3.2
Net purchases of goods and services	-1.0	18.7	10.1	14.6	10.5	14.3	1.5
Consumption of fixed capital	11.3	12.6	14.2	12.3	8.0	10.4	7.3
Gross saving	18.0	84.4	-32.2	-53.2	-11.2	—	-0.4
Capital revenue	50.4	37.0	5.1	31.7	12.0	17.9	12.6
Capital taxes	36.1	6.3	11.7	-8.9	24.3	17.9	12.5
Capital transfers	63.8	60.9	1.8	54.6	7.9	17.9	12.6
Public investment	23.7	29.7	26.3	7.2	-8.9	4.4	-2.6
Gross fixed capital formation	24.2	33.8	23.2	8.7	-9.1	4.5	-2.6
Net purchases of land	15.1	-64.4	—	-31.2	-3.6	3.8	-3.5
Capital transfers paid	10.0	25.4	-15.5	10.7	4.2	25.0	-10.2
Net lending (+) or net borrowing (-)	15.6	-3.5	63.1	30.7	-7.9	84.5	-5.5
MEMORANDUM ITEMS:							
Primary deficit	11.1	17.9	10.7	11.8	12.0	3.3	4.8
Total revenue	10.8	18.3	10.6	9.7	12.4	0.8	6.9
Tax revenue	11.4	16.2	14.2	13.6	9.9	10.7	3.2
Total expenditure	11.5	18.3	17.1	12.1	7.8	6.0	1.9
Final demand	11.0	14.4	11.7	11.7	12.2	12.9	7.6
State net lending (+) or net borrowing (-)	-6.5	-18.5	49.5	-13.0	6.2	177.5	-11.5
Nominal GDP growth	11.2	12.2	11.3	9.5	7.5	3.2	6.2

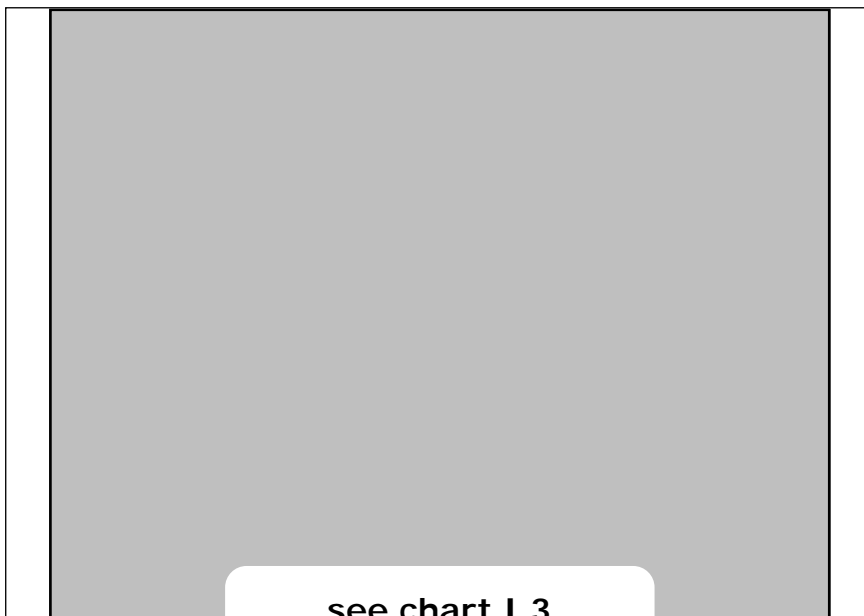
Sources: Ministerio de Economía y Hacienda and Banco de España.

DEFICIT AND PRIMARY DEFICIT

Sources: Ministerio de Economía y Hacienda and Banco de España.

Of the main determinants of the growth of aggregate public spending, welfare benefits exhibit the biggest rate of increase. This is especially so from 1990 to 1993, when their nominal growth was, on average, almost six percentage points higher than that of GDP at current prices. The drastic slowdown witnessed over the past two years, when their nominal growth plunged from almost 14 % to 4.3 %, did not prevent the growth of their weight in relation to GDP (by 0.6 points, up to 16.7 %, 2.9 percentage points more than in 1987). This was as a result of the slackness of economic activity in 1993 (nominal GDP grew by only 3.2 %) and despite the cut of three-tenths of a point of GDP made in 1994. Table I.3 offers a classification of welfare benefits under various headings. As can be seen, it is economic benefits (as opposed to health-care or in-kind benefits) that are most preponderant. Within these economic benefits, contributory pensions account for almost 53 % of total benefits, while unemployment benefits represent 18.7 % of the aggregate (1.1 percentage points more than in 1988, as a result of the economic recession and of the increase in the eligibility rate, which was partly corrected in 1994). Though of secondary significance, the relative weight of benefits for provisional invalidity (1 %) and non-contributory pensions (1.3 %) is increasing, while benefits for temporary labour disability inverted this trend as a result of the changes

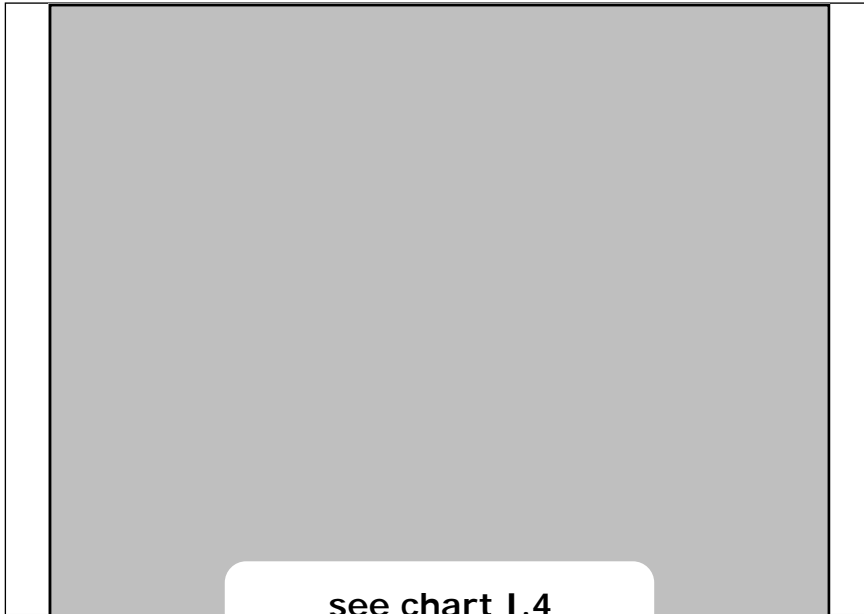
**PUBLIC DEBT
GENERAL GOVERNMENT LEVELS**



Sources: Ministerio de Economía y Hacienda and Banco de España.

in the regulations governing them in 1992 to curb the budgetary overrun recorded in prior years (caused by the fraudulent use of these benefits).

The trend growth of benefits raises doubts about their future financing. In years of low growth, the weight of these benefits in relation to GDP may reasonably be expected to increase due either to the impact of the cycle (on unemployment and other benefits, via an increase in fraud or in early retirements), or to the unresponsiveness to the cycle of many benefits (which depend on structural factors, such as the aging of the population). To illustrate the problems of the future sustainability of benefits, table I.4 details their excess nominal growth in terms of GDP. Every year, except 1994, the increase in benefits is greater than that in GDP at current prices. The systematic upward bias is more evident in the case of contributory pensions and health-care benefits. And adding to these have been non-contributory benefits and those for temporary labour disability and provisional invalidity (although they are of quantitatively lesser significance). That said, the accelerated increase in non-contributory benefits is attributable to their recent introduction (in place, moreover, of other benefits, such as those assigned to the social integration of the disabled). Noteworthy in 1994, in addition to the aforementioned effect on tempo-

BUDGET DEFICIT AND ECONOMIC GROWTH

Sources: Ministerio de Economía y Hacienda and Banco de España.

rary labour disability, is the fact that the measures adopted in 1992 and 1993 to contain spending on unemployment benefits provided for a reduction in this item. In short, it may be deduced from Table I.4 that the trend growth of benefits is far higher than that of GDP. Indeed, even a rapid recovery in economic activity to growth rates close to potential would not guarantee a check on the progressive rise in the weight of welfare benefits as a proportion of GDP. That raises doubts about the future sustainability of such benefits and about the current financing arrangements for them.

After benefits, government consumption is the component that has most contributed to increasing the weight of public spending in terms of GDP. Between 1987 and 1994 its share in GDP climbed by 1.9 percentage points. This was the result of strong growth in nominal terms between 1989 and 1992, in turn the outcome of the growth in compensation per employee, owing both to the expansion of employment in the public sector (which increased by an annual average of 4.6 % between 1989 and 1992) and to wage rises (in annual average terms compensation per employee grew by 9.4 % over this period). This growth sharply declined in 1993 and 1994 further to the wage-restraint and staffing-freeze measures adopted under the respective Budgets for these two years (com-

TABLE I.2

GENERAL GOVERNMENT DEFICIT AND DEBT
% of GDP

	1987	1988	1989	1990	1991	1992	1993	1994
General government deficit	3.1	3.3	2.8	4.1	4.9	4.2	7.5	6.7
State + Central Government								
Administrative Agencies	3.5	2.9	2.2	2.9	2.5	2.3	6.0	5.1
Social Security	-0.3	0.0	-0.2	0.2	0.8	0.7	0.1	0.5
Autonomous Communities	-0.1	0.3	0.6	0.8	1.4	1.0	1.1	1.0
Local Governments	0.0	0.0	0.2	0.2	0.2	0.2	0.2	0.1
Primary deficit	-0.3	-0.1	-0.7	0.4	1.0	-0.0	2.2	1.4
Gross public debt	45.5	41.7	43.2	45.1	45.8	48.4	60.4	63.0
Of the State	41.5	37.4	36.8	38.7	38.4	40.3	51.1	52.8

Sources: Ministerio de Economía y Hacienda and Banco de España.

pensation per employee is estimated to have grown by 3.3 % in annual average terms, and employment by 0.1 %).

Turning to public investment, its weight as a proportion of GDP climbed 0.5 percentage points between 1987 and 1994, from 3.4 % to 3.9 % of GDP, peaking at 5 % in 1990. This notable increase in public investment meant that, in 1989, the so-called "golden rule" of public finance in its strictest version could once again be met; namely, that the budget deficit did not exceed *net* general government investment. However, the fact that this rule should once again have been met (after ten years of excessive deficits) as a result of the increase in investment above what would be sustainable in the medium term (rather than as a result of the deficit diminishing), and against the background of a rapid expansion in aggregate demand, had a substantial destabilising effect: it exacerbated the disequilibria that had built up in the Spanish economy and thus contributed to check the pace of economic growth.

In the period 1988-1994, the interest burden/GDP ratio increased by 1.9 percentage points to 5.3 % of GDP in 1994. Behind this development were the effects of (i) the growing stock of outstanding government debt; (ii) the increase in the portion of this stock financed at market prices; and (iii) the uptrend of the primary deficit, especially as from 1990. The expansion of this public spending caption clearly illustrates the deficit feedback effects caused by its increase in recent years, as well as the reduction of fiscal policy leeway that this increase in the debt burden entails. For this expenditure component to moderate, the primary deficit

TABLE I.3

COMPOSITION OF WELFARE BENEFITS
Percentages

	1988	1989	1990	1991	1992	1993	1994
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Economic benefits	91.7	91.0	90.7	90.5	90.4	91.0	90.9
General government, excluding Social Security	10.4	10.3	10.1	10.1	10.5	9.6	9.4
Social Security	81.4	80.8	80.6	80.4	79.9	81.4	81.4
System	59.3	59.2	58.8	57.3	57.4	58.2	60.5
Contributory pensions	53.1	53.0	52.4	50.6	49.5	50.6	52.9
Temporary labour disability .	4.7	5.0	5.3	5.5	5.3	4.6	4.3
Provisional invalidity	0.6	0.5	0.5	0.6	0.7	0.8	1.0
Non-contributory pensions. .	—	—	—	0.1	0.6	1.0	1.3
Non-contributory family allowances	—	—	—	0.0	0.1	0.1	0.4
Contributory family allowances	0.6	0.5	0.4	0.4	0.9	0.8	0.5
INEM (National Employment Office)	19.5	19.4	19.7	21.0	20.9	22.0	19.8
Unemployment	17.6	17.5	17.9	19.3	19.8	20.5	18.7
Other Social Security	2.5	2.1	2.0	1.9	1.5	1.0	1.0
Benefits transferred to Autonomous Communities. .	0.1	0.1	0.1	0.1	0.1	0.2	0.2
Benefits in kind	0.7	1.0	1.3	1.5	1.1	0.9	0.8
Health-care benefits	7.6	7.9	8.0	8.1	8.4	8.1	8.3
System (a)	2.7	3.0	2.9	2.5	2.4	2.4	2.3
Other Social Security	1.8	1.6	1.7	1.6	1.8	1.6	1.4
Benefits transferred to Autonomous Communities .	3.1	3.4	3.5	3.9	4.2	4.1	4.6

Sources: Ministerio de Economía y Hacienda and Banco de España.

(a) Mainly medication.

– i.e. the rest of the public-finance components – must evidently be controlled.

The detailed examination of revenue reveals that in the period 1988-1994 it has risen as a proportion of GDP by 3.8 percentage points, 2.7 points of which relate to the increase in tax revenue, and the remainder to foreign transfers (from the EU) and to atypical revenue (such as those arising from the extraordinary profits of the Banco de España in 1992 and 1993, or from privatisation proceeds). Significantly, there was a slight downtrend in taxes linked to production and imports, the ratio of which to GDP slipped by 0.2 percentage points between 1987 and 1994. Although this is due to the progressive lowering of tariff barriers (which started with

TABLE I.4

**BENEFITS: DIFFERENCE IN RELATED RATES OF CHANGE COMPARED
WITH THAT OF GDP**

	1988	1989	1990	1991	1992	1993	1994
TOTAL	0.3	0.8	3.5	6.3	6.6	5.6	-2.3
Economic benefits	-1.1	-0.1	3.1	5.9	6.6	6.4	-2.4
General government, excluding Social Security	-5.0	-0.5	1.7	6.3	11.4	-3.8	-4.4
Social Security	-0.6	0.0	3.3	5.9	6.0	7.7	-2.2
System	0.1	0.7	2.7	3.3	6.7	7.1	1.9
Contributory pensions	0.3	0.6	2.2	2.2	4.3	7.9	2.4
Temporary labour disability ...	3.4	8.7	9.4	11.0	3.3	-8.7	-10.9
Provisional invalidity	-13.3	-8.1	4.1	22.0	22.5	28.2	15.7
Non-contributory pensions ..	—	—	—	—	804.9	71.8	33.3
Non-contributory family allowances	—	—	—	—	589.4	21.2	295.2
Contributory family allowances	-14.4	-13.6	-14.6	-8.3	148.0	-0.8	-44.0
INEM (National Employment Office)	-0.5	0.2	5.0	14.1	6.0	11.7	-12.6
Unemployment	-3.0	0.5	5.9	15.4	9.5	9.3	-11.1
Other Social Security	-19.0	-17.5	1.5	0.6	-18.3	-27.7	-11.9
Benefits transferred to Autonomous Communities .	—	7.8	20.6	13.7	13.9	18.6	-3.9
Benefits in kind	43.5	54.1	34.5	23.1	-19.3	-19.3	-10.5
Health-care benefits	16.9	6.5	4.2	7.2	11.9	1.5	0.4
System(a)	-51.5	13.6	-0.1	-9.8	3.6	7.5	-7.5
Other Social Security	11.1	-9.1	6.5	5.8	20.1	-8.8	-12.3
Benefits transferred to Autonomous Communities .		9.2	6.9	22.1	13.7	2.5	10.1
MEMORANDUM ITEM:							
Nominal GDP growth	11.2	12.2	11.3	9.5	7.5	3.2	6.2

Sources: Ministerio de Economía y Hacienda and Banco de España.

(a) Mainly medication.

Spanish accession to the EU in 1986) and to the growing share of the EU in the revenue raised on these taxes in Spain, the decline is admittedly striking; all the more so if the tax increases of recent years in VAT and in excise duties are taken into account. Likewise, consideration should be given to the management shortcomings and fraud affecting these taxes when explaining the decline.

Taxes on income and wealth ran in an opposite direction, with their share in GDP increasing by 1.1 points between 1987 and 1994 (2.1 points to 1992). Chiefly, this was the result of developments in personal income tax, the related revenue for which has not been very affected by

BREAKDOWN OF TAX REVENUE
(As a % of GDP)

	1987	1988	1989	1990	1991	1992	1993	1994
TOTAL (EXCEPT SOCIAL SECURITY CONTRIBUTIONS) ..	20.9	21.1	22.6	22.2	22.1	22.8	21.8	21.9
Taxes on income and net worth	10.3	10.4	12.1	12.0	12.0	12.4	11.9	11.4
Personal income tax	7.0	7.2	8.0	7.7	8.2	8.9	8.6	8.4
<i>Withholdings on earned income</i>	<i>4.6</i>	<i>4.6</i>	<i>4.9</i>	<i>5.5</i>	<i>6.0</i>	<i>6.1</i>	<i>6.3</i>	<i>6.3</i>
<i>Withholdings on capital</i>	<i>0.8</i>	<i>1.0</i>	<i>1.2</i>	<i>1.5</i>	<i>1.5</i>	<i>1.5</i>	<i>1.6</i>	<i>1.5</i>
<i>Net tax payable and other</i>	<i>1.6</i>	<i>1.6</i>	<i>1.9</i>	<i>0.7</i>	<i>0.7</i>	<i>1.3</i>	<i>0.7</i>	<i>0.7</i>
Net worth tax	0.1	0.1	0.1	0.2	0.1	0.1	0.2	0.2
Corporate income tax	2.3	2.2	3.1	3.2	2.7	2.4	2.1	1.9
<i>Withholdings on capital</i>	<i>0.7</i>	<i>0.4</i>	<i>0.5</i>	<i>0.7</i>	<i>0.7</i>	<i>0.7</i>	<i>0.7</i>	<i>0.6</i>
<i>Net tax payable and other</i>	<i>1.6</i>	<i>1.8</i>	<i>2.6</i>	<i>2.5</i>	<i>2.0</i>	<i>1.8</i>	<i>1.5</i>	<i>1.3</i>
Other	0.8	0.9	0.9	1.0	1.0	1.0	1.0	1.0
Taxes on capital	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.3
Inheritance tax	0.2	0.2	0.2	0.2	0.1	0.2	0.2	0.2
Special duties	0.0	0.1	0.1	0.1	0.0	0.1	0.1	0.1
Taxes linked to production and imports	10.4	10.4	10.3	9.9	9.8	10.2	9.6	10.2
Value added tax	5.1	5.1	5.4	5.0	4.9	5.3	4.6	5.0
Taxes linked to production	4.4	4.4	4.2	4.4	4.5	4.6	4.8	5.1
Taxes linked to imports	1.0	0.9	0.7	0.6	0.5	0.3	0.1	0.1

Sources: Ministerio de Economía y Hacienda and Banco de España.

TABLE I.5

BREAKDOWN OF TAX REVENUE (contd.)
(Rate of change)

	1988	1989	1990	1991	1992	1993	1994
TOTAL (EXCEPT SOCIAL SECURITY CONTRIBUTIONS)	120	20.5	9.0	9.0	11.3	-1.7	6.8
Taxes on income and net worth	13.3	29.4	10.8	9.7	10.9	-1.0	2.0
Personal income tax	13.9	24.5	6.8	17.4	16.0	0.2	4.2
<i>Withholdings on earned income</i>	11.7	19.6	23.7	20.2	9.4	6.6	6.1
<i>Withholdings on capital</i>	33.8	27.9	45.8	11.5	6.4	6.1	0.3
<i>Net tax payable and other</i>	9.9	36.4	-59.5	8.5	94.5	-38.5	-3.1
Net worth tax	28.5	-37.0	169.4	-20.1	12.9	6.4	8.3
Corporate income tax	6.5	55.1	15.1	-5.4	-4.6	-8.9	-8.0
<i>Withholdings on capital</i>	-34.7	23.1	56.5	14.1	2.2	5.7	-4.8
<i>Net tax payable and other</i>	25.8	62.9	7.5	-10.7	-6.9	-14.4	-3.4
Other	24.3	16.4	17.2	4.8	11.2	7.2	3.1
Taxes on capital	36.1	6.3	11.7	-8.9	24.3	17.9	12.5
Inheritance tax	39.0	1.4	8.5	-4.8	26.6	23.0	12.2
Special duties	27.2	23.4	20.6	-19.3	17.3	1.6	13.8
Taxes linked to production and imports	10.3	11.9	6.8	8.5	11.4	-3.0	12.5
Value added tax	11.0	19.3	1.9	8.2	16.9	-10.1	14.3
Taxes linked to production	10.8	7.4	16.7	12.1	9.6	9.1	11.5
Taxes linked to imports	4.4	-7.6	-12.8	-15.8	-28.8	-61.3	-17.0
MEMORANDUM ITEM:							
Nominal GDP growth	11.2	12.2	11.3	9.5	7.5	3.2	6.2

Sources: Ministerio de Economía y Hacienda and Banco de España.

TABLE I.6

**CURRENT AND CAPITAL TRANSFERS DELIVERED BY
THE STATE TO OTHER GENERAL GOVERNMENT SECTORS
% of GDP**

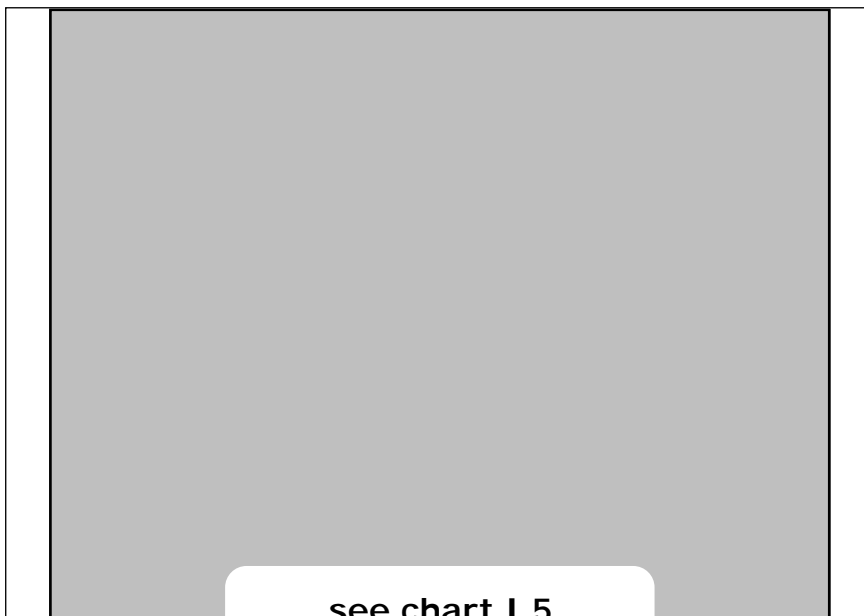
	1988	1989	1990	1991	1992	1993	1994
Current transfers	8.8	9.1	8.9	9.1	10.1	11.3	11.1
Central government							
Administrative agencies	0.4	0.4	0.4	0.5	0.6	0.7	0.6
Social Security	4.5	4.6	4.4	4.5	4.9	5.9	5.8
INEM	1.1	1.1	1.0	0.9	1.2	1.6	1.4
Autonomous Communities	2.5	2.6	2.6	2.6	3.0	3.1	3.1
Share in State revenue	1.9	2.0	2.0	1.7	2.4	2.9	2.9
Local governments	1.4	1.5	1.5	1.6	1.7	1.6	1.6
Share in State revenue	1.3	1.4	1.4	1.5	1.6	1.5	1.6
Capital transfers	1.0	1.2	1.4	1.1	1.3	1.6	0.6
Central government							
administrative agencies	0.3	0.4	0.5	0.3	0.3	0.4	0.2
Social Security	0.0	0.0	0.1	0.1	0.4	0.8	0.1
INEM	—	—	0.0	0.0	0.3	0.8	0.0
Autonomous Communities	0.5	0.7	0.7	0.6	0.5	0.4	0.3
Local governments	0.1	0.1	0.1	0.1	0.1	0.1	0.0

Sources: Ministerio de Economía y Hacienda and Banco de España.

the reform that came into force in 1992. Regarding corporate income tax, after the related revenue peaked at 3.2 % of GDP in 1990 (a result stemming from the corporate profits of the previous years), it slid to 1.9 % in 1994, due mainly to the impact of the recession on the tax base. It should be clarified that the strong rise in 1989 (29.4 %) in these taxes is attributable to discretionary measures, such as the transfer of personal income tax refunds (totalling PTA 323 billion) to 1990, the increase in the proportion of corporate income tax prepayments or the rise in withholdings on capital income (from 20 % to 25 %).

Social security contributions, for their part, have increased as a proportion of GDP, rising by 1.6 percentage points to 14.4 % of GDP in 1994. The strength of revenue relating to this item (their average nominal growth between 1988 and 1994 was 10.6 %, compared with average growth of nominal GDP of 8.7 %) is due, in part, to the measures adopted in the past three years to raise rates and widen bases (between 1992 and 1994, the average growth of contributions was 8.7 %, against average growth of GDP of 5.6 %). However, the adverse impact on employment that would ultimately result from the continuous tax increases needed to sustain the advance of social security contributions has prompted, in

**GOVERNMENT CONSUMPTION
GENERAL GOVERNMENT LEVELS**

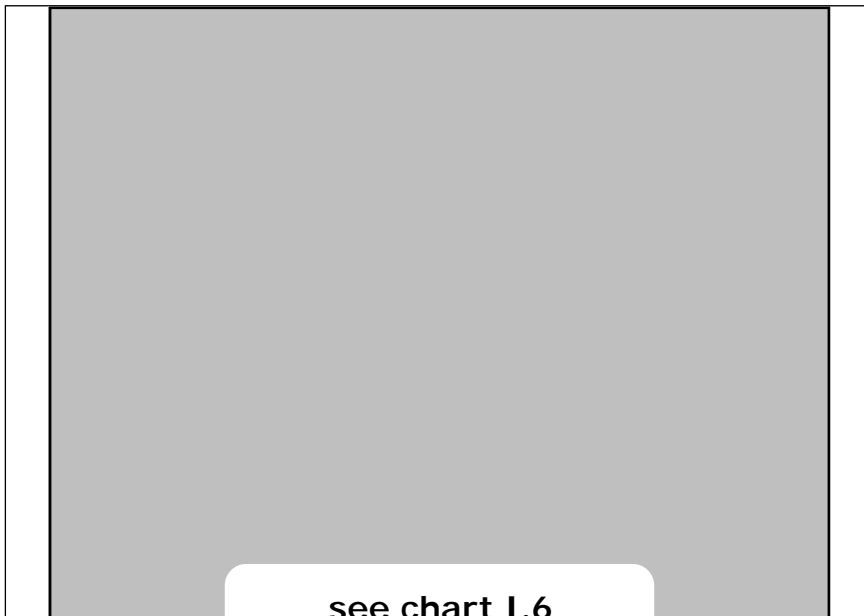


Sources: Ministerio de Economía y Hacienda and Banco de España.

1995, a lowering of the contribution rates which could bring to a halt the upward trend in this revenue in recent years.

Part of the buoyancy in revenue as a whole is attributable to developments in the “other revenue and transfers” caption. From 1987 to 1994, the weight of this item in GDP increased by 0.7 percentage points, reaching 4.6 percentage points in 1994. This growth is due to dividend proceeds related to capital gains arising on the privatisation of certain State-owned companies (those belonging to INH – the National Hydrocarbons Institute –) and to the exceptionally high profits of the Banco de España in 1992 and 1993. Insofar as the factors behind this increase are non-recurrent or one-off, the 0.7 percentage points increase in terms of GDP may be affirmed to be temporary. That will have a bearing on the future sustainability of the current revenue/GDP ratio. The risks, then, of a greater overrun in the budget deficit once these temporary-improvement factors disappear or weaken – as has begun to occur in 1994 and 1995 – are therefore high, and mean the drive to reduce the deficit via the containment of spending must be intensified.

**PUBLIC INVESTMENT
GENERAL GOVERNMENT LEVELS**



Sources: Ministerio de Economía y Hacienda and Banco de España.

Turning to capital revenue, its rise by 0.6 percentage points of GDP from 1987 to 1994 is due entirely to the increase in transfers from the EU. Once again, this is an uncertain and relatively uncontrollable factor, particularly as regards the cohesion funds, the receiving of which may be conditional, in principle, upon meeting the targets set in convergence programmes.

On analysing the contribution of the various agents to the growth of the budget deficit (which increased by 3.6 percentage points of GDP between 1987 and 1994, as shown in Table I.2), the State (i.e. central government excluding government agencies), with a contribution of 1.6 points of GDP, is seen as the agent to have pursued the most expansionary policy. That said, territorial (regional and local) governments, with 1.2 points of GDP, and Social Security Funds, with 0.8 points, together contribute over 50 % of the increase in the budget imbalance. In any event, this apparently more expansionary behaviour of the State and its agencies is indicative of the problems of excessive growth in spending and of the lack of budgetary discipline in the general government sector as a whole. Such problems are more intensely manifest in the State sector

TABLE I.7

**GOVERNMENT CONSUMPTION AND PUBLIC INVESTMENT
BREAKDOWN BY AGENT
% of GDP**

	1987	1988	1989	1990	1991	1992	1993	1994
Government consumption	15.1	14.8	15.2	15.6	16.2	17.0	17.5	17.0
Percentage shares								
Central government	66.9	66.1	66.0	64.0	63.2	63.8	63.8	63.1
<i>State + Central</i>								
<i>Gvt. Administrative</i>								
<i>Agencies</i>	45.6	43.2	41.6	39.6	38.2	36.7	37.4	36.4
<i>Social Security</i>	21.2	22.9	24.3	24.4	25.0	27.1	26.5	26.7
Territorial								
governments	33.1	33.9	34.0	36.0	36.8	36.2	36.2	36.9
<i>Autonomous</i>								
<i>Communities</i>	16.5	16.8	17.2	18.1	18.4	18.5	18.4	18.7
<i>Local governments . . .</i>	16.7	17.2	16.9	17.9	18.4	17.7	17.8	18.2
Public investment	3.4	3.8	4.4	5.0	4.9	4.2	4.2	3.9
Percentage shaes								
Central government	37.8	37.8	38.2	39.5	39.1	35.9	40.4	38.6
<i>State + Central</i>								
<i>Gvt. Administrative</i>								
<i>Agencies</i>	32.3	32.7	32.0	33.6	33.0	30.1	34.5	33.1
<i>Social Security</i>	5.5	5.1	6.2	6.0	6.0	5.8	5.9	5.5
Territorial								
governments	62.2	62.2	61.8	60.5	60.9	64.1	59.6	61.4
<i>Autonomous</i>								
<i>Communities</i>	31.7	31.1	31.0	30.8	35.1	36.3	34.6	34.9
<i>Local governments . . .</i>	30.6	31.1	30.8	29.6	25.8	27.9	25.1	26.4

Sources: Ministerio de Economía y Hacienda and Banco de España.

since the other agents depend on transfers from the State. As Table I.6 reveals, current and capital transfers delivered by the State to other general government sectors respectively account in 1994 for 11.1 and 0.6 points of GDP. The former have increased since 1988 by 2.3 points of GDP, while the latter have slid by 0.4 points of GDP since the same year. The decline of capital transfers was centred on 1994, when their share in GDP fell by a point. Under this increase by 1.9 points of GDP in total transfers, 74 % corresponded to Social Security Funds and 21 % to the "Autonomous Communities" (regional governments). If the contributions of the various agents to the growth of the budget deficit are weighted taking into account the interplay of transfers received by the State, the prob-

TABLE I.8

GOVERNMENT CONSUMPTION AND PUBLIC INVESTMENT
Rate of change by agent

	1988	1989	1990	1991	1992	1993	1994
Government consumption.....	8.7	15.3	14.4	13.7	12.9	6.4	3.0
Central government.....	7.4	15.1	11.0	12.1	14.0	6.4	1.9
<i>State + Central</i>							
<i>Gvt. Administrative Agencies .</i>	2.9	11.1	8.9	9.5	8.5	8.3	0.3
<i>Social Security.....</i>	17.0	22.7	14.7	16.3	22.5	3.9	4.1
Territorial governments.....	11.3	15.7	20.9	16.4	10.9	6.4	5.0
<i>Autonomous Communities ...</i>	10.6	18.1	20.3	16.1	13.0	6.0	4.7
<i>Local governments.....</i>	12.0	13.2	21.4	16.8	8.8	6.7	5.4
 Public investment.....	 23.7	 29.7	 26.3	 7.2	 -8.9	 4.4	 -2.6
Central government.....	23.8	31.0	30.7	5.9	-16.3	17.5	-6.9
<i>State + Central</i>							
<i>Gvt. Administrative Agencies .</i>	25.3	27.2	32.3	5.5	-17.0	19.7	-6.5
<i>Social Security.....</i>	15.1	55.4	22.5	8.3	-12.7	6.3	-9.0
Territorial governments.....	23.7	28.8	23.6	8.1	-4.2	-2.9	0.2
<i>Autonomous Communities ...</i>	21.7	29.0	25.7	22.1	-5.9	-0.4	-1.6
<i>Local governments.....</i>	25.7	28.7	21.4	-6.5	-1.8	-6.1	2.8
MEMORANDUM ITEM:							
Nominal GDP growth.....	11.2	12.2	11.3	9.5	7.5	3.2	6.2

Sources: Ministerio de Economía y Hacienda and Banco de España.

lem of the budget deficit is confirmed to be one of the general government sector as a whole. And noteworthy thereunder as the sub-sector with most difficulties is Social Security Funds, coinciding with the fact that welfare benefits are the spending component that has most increased relatively in recent years.

It is no accident that the biggest increase in the State deficit should coincide with the economic recession. Indeed, if the State deficit reflects the problems of the general government sector as a whole, this is all the more so at times of recession. The reason lies, first, in the cyclical insensitivity of the revenue and expenditure of the Autonomous Communities (State transfers to the regional governments are little affected by the cycle); and second, in the bigger transfers the State makes to Social Security Funds so that the latter may cover the shortfall arising between benefits, which increase (unemployment benefits in particular), and contributions, which slow down as a result of employment developments. Thus, up to 1992, the increase in the budget deficit by 1.1 points of GDP since 1987 was due in its entirety to the contribution of Social Security Funds (one point of GDP) and of the territorial governments (1.3 points of

GDP), while the State deficit declined by 1.2 points of GDP over the same period.

This conclusion is bolstered when the nominal growth of final demand (of government consumption and public investment) in the various general government agents is observed (Charts I.5 and I.6, and Table I.7). In principle, there appear to have been no major variations in the relative weights of the various general government agents. Hence, under government consumption, a slight rise is perceptible in the relative weight of territorial governments, which might be due to the headway made in transferring powers to the Autonomous Communities. Such headway is in contrast to the decline in the investment role played by the territorial governments, which is entirely in response to a lesser investment drive by local governments. Noteworthy under central government is the strong growth of government consumption by Social Security Funds, the weight of which in the total is more than five percentage points up, a fact which accounts for 60 % of the increase in the government consumption/GDP ratio.

Table I.8 shows the nominal growths of government consumption and public investment. It can be seen that the relative stability of their shares masks differing trends. Specifically, as regards government consumption, it is Social Security Funds and the territorial governments which, with the exception of 1993, evidence most growth; in all years except 1994, the surging growth of consumption by these sectors outstripped nominal GDP growth. Turning to public investment, the State and the territorial governments (Social Security Funds has a residual investor weight) show similar behaviour, expanding strongly between 1988 and 1990, and contracting between 1991 and 1994. In 1993, however, they follow different courses: whereas the Autonomous Communities show a certain moderation, the State is seen to heighten its investment drive, with nominal growth at almost 20 %. In short, both the role of the State, as the distribution pivot for funds or transfers, and the expansion of government consumption in non-central governments confirm that the heavy deterioration of the State deficit is but the reflection of the problems existing in the general government sector as a whole.

It may thus be concluded that from 1988 to 1994 there was an intense worsening of the budgetary imbalance. The deterioration was particularly notable in 1993, with 1994 marking the start of a modest correction. True, part of the deterioration was due to the impact of the crisis on the course of general government revenue and expenditure. But undoubtedly reflected too is a permanent increase in public spending, underpinned by the extension of welfare-state entitlement spending. This trend was in contrast to that in the rest of the EU, where it is essentially the fall in revenue (caused by various fiscal reforms) that is behind the widening

tendency of the budget deficit in recent years. In Spain, indeed, public revenue is increasing, albeit by an insufficient amount to prevent the widening of the budget deficit.

Leaving aside the impact of the crisis, there is one key fact relating to public revenue and expenditure that may affect the possibility of correcting and even containing the budget deficit in the coming years. Namely, while the increase in public spending is of a permanent nature (since it is largely attributable to the extension of entitlement spending), the rise in revenue is transitory and uncertain, as over 30 % of this increase was not due to tax rises but to circumstances that were extraordinary (dividend revenue related to the privatisation of certain State-owned companies or the exceptionally high profits of the Banco de España in 1992 and 1993) or uncontrollable (the rise in transfers received from the EU, which may be partly linked to compliance with the objectives of national convergence programmes). Thus, in 1994 the recovery in tax revenue did not prevent a decline in total revenue, as a percentage of GDP, owing primarily to the fall in resources arising from the profits of the Banco de España. This particular combination (permanent increases in spending and transitory – in part – increases in revenue) advises extreme rigour in controlling public spending if a further widening of the deficit is to be avoided in the coming years (2).

(2) Significant in this respect is the State deficit in 1994. A slight budgetary deviation occurred which, unlike previous years, came about on the revenue side since the forecasts for privatisation proceeds were not met and a large portion of the capital transfers from EU funds were delayed. The cut in spending in relation to the initial budget projection was unable to offset these revenue deviations.

II

FISCAL POLICY STANCE

The previous chapter analysed the behaviour of government revenue and expenditure captions. This chapter analyses the stance of fiscal policy and, concretely, strives to evaluate whether fiscal policy has had a stabilising effect at the macroeconomic level. This is not an obvious question, because fiscal policy not only affects activity but is also automatically affected by it via both spending and revenue.

On the expenditure side, although unemployment benefits should be the only item with pronounced cyclical sensitivity, other expenditure components can, in fact, show a certain cyclical sensitivity. In this respect, though there is no reason why pension payments should depend on the economy's cyclical position, the fact is that recession, with the job destruction it engenders, encourages early retirement. This is due not only to the greater difficulty in finding employment but also to the launch of corporate reconversion programmes, in which the most frequent job-leaving incentives involve severance payments and early retirement schemes. Similarly, benefits such as payments for temporary labour disability and provisional invalidity (which should depend solely on industrial accidents) exhibit a certain cyclical pattern, since they are sometimes used by firms as a way of temporarily adjusting staffing levels and, consequently, as a means of coping with the impact of recession on corporate profits. Even interest payments on debt can be affected to some extent – albeit in a different direction and depending on many other circumstances – by cyclical trends in the economy, insofar as recession is associated with lower nominal and real interest rates, and expansionary periods with higher rates.

On the revenue side, the problem is that not all taxes show the same cyclical sensitivity: whereas corporate and personal income taxes are highly sensitive (evidenced in the elasticity of takings to nominal GDP, which is higher than unity), taxes on consumption, such as VAT and excise duties, are generally cyclically neutral, with the exception of the impact of the change in the composition of aggregate demand and the influ-

ence of the business cycle on consumer tax evasion (such that the elasticity of their takings is about unity in relation to nominal GDP). Moreover, these elasticities of taxes to business also vary over time, either as a result of regulatory changes or of more effective tax implementation (a greater degree of fiscal compliance or improvements in tax administration, for example).

A further problem when analysing the discretionary component of fiscal policy – the change in revenue and expenditure – is that it is difficult to calculate the economic impact of specific legislative measures over time. This is due to the time lag in their effects and also to the reactions caused by the anticipation of regulatory changes, which operate through the expectations of economic agents. Thus, the increase in the entitlement of individuals to receive unemployment benefits, a legislative measure taken in 1989, had no significant discretionary impact until the slowdown in activity became a crude reality. Fiscal policy was discretionarily expansionary in 1989, even though its impact on public spending – reflected in the composite indicators of fiscal policy – would not become apparent until years later. By contrast, the announced modification in the compatibility of severance payments for dismissals and unemployment benefits (proposed in parliament in the autumn of 1993 for enforcement in early 1994 but later withdrawn) was unquestionably a factor in the rise in the number of dismissals at the time.

Briefly stated, in a simplified and summary analysis it is difficult to pinpoint whether a change in fiscal policy is discretionary or automatic. Due to the problems posed in calculating and evaluating the cyclical component over time (which is hard to estimate if, for example, discretionary measures also alter the cyclical sensitivity of revenue and expenditure), it is difficult to give a precise answer to the question of what the fiscal policy stance is at any given time. This study uses two evaluation methods that seem to act more as complements than as alternatives. First, in this chapter, the composite indicators of fiscal policy stance (concretely, the fiscal impulse indicators proposed by the IMF) are analysed to evaluate whether fiscal policy has had a stabilising effect. Second, in Appendix 1, the main discretionary measures taken in recent years are examined in detail, and a more specific evaluation is made of the discretionary components implicit in the different revenue and expenditure captions.

II.1. Fiscal impulse in Spain: 1988-1994

In seeking to ascertain and measure, as far as is possible, the contractionary or expansionary impulse of fiscal policy, one of the first problems encountered is the endogeneity of fiscal policy with respect to the

business cycle. This endogeneity invalidates the use of the current budget balance as a reliable indicator of discretionary government action, because the budget is affected by trends in economic activity which, as a general rule, do not coincide with initial forecasts. This dependence is the product of the higher-than-unity elasticity of several components of revenue (direct taxation) and expenditure (mainly unemployment benefits) that make up the well-known mechanism of automatic stabilisers.

This chapter uses a fiscal policy indicator that, by adjusting the variables of government revenue and expenditure for the effect of the business cycle, reflects the stance of fiscal policy and, thus, the reaction of the economic authorities to changes in the economic climate, while also signalling the likely behaviour of future fiscal policy in the light of its current stance. The indicator used is that of fiscal impulse, based on the methodology developed by the IMF (1). A positive fiscal impulse signifies a discretionarily contractionary policy stance, and vice versa in the case of a negative impulse.

Table II.1 shows the calculation of this indicator for the whole of the general government sector from 1988 to 1994. An initial conclusion that can be drawn from this table is that the fiscal policy stance was expansionary in the period in question, with the exception of 1992 and 1994, when it was contractionary. The slightly contractionary nature of fiscal policy in 1989 is solely due to the transfer of more than PTA 300 billion (the equivalent of 0.7 percentage points of GDP) in personal income tax refunds to the year 1990. If adjusted for this effect, the resulting figure indicates an expansionary impulse in fiscal policy in 1989 and also an easing in fiscal expansion in 1990.

As to the efforts to control the budget deficit in 1992, the impact was greater than that derived from the modest reduction in the budget imbalance, which decreased by only 0.7 points of GDP, prompted by the intensification of the slowdown in economic activity that began in 1989. For 1993, the use of this indicator confirms that the surge in the budget deficit that year by more than 3 points of GDP can only be partly explained by the impact of the recession, which accounted for 30 % of the aforementioned increase. The deterioration in the budget imbalance in 1993 must therefore be attributed to a change in the stance of fiscal policy, which undermined the consolidation process and led to a short-term expansionary impulse that added to the business cycle's automatic impact on government accounts. In 1993 the need to correct the budget deficit became a secondary concern, because the priority was to counteract the adverse effects of the recession by increasing public spending. In 1994 fiscal poli-

(1) For a more detailed description of this and other indicators, see A.L. Gómez Jiménez (1993).

TABLE II.1

FISCAL IMPULSE INDICATOR (IMF). GENERAL GOVERNMENT
% of GDP

	1988	1989	1990	1991	1992	1993	1994
Deficit (a)	-3.3	-2.8	-4.1	-4.9	-4.2	-7.5	-6.7
Change in deficit	-0.1	0.5	-1.3	-0.8	0.7	-3.3	0.8
Fiscal impulse (b)	-0.4	0.2	-1.5	-0.7	1.1	-2.3	0.7
Fiscal impulse revenue (b)	-0.0	1.9	-0.2	0.8	1.7	0.0	-0.6
Fiscal impulse expenditure (c). .	0.4	1.8	1.3	1.6	0.6	2.3	-1.2
Cyclical effect	0.3	0.3	0.2	-0.1	-0.4	-1.1	0.2
Primary deficit (d)	0.1	0.7	-0.4	-1.0	0.0	-2.2	-1.4
Change in primary deficit	-0.2	0.6	-1.0	-0.6	1.0	-2.3	0.9
Primary fiscal impulse (b)	-0.5	0.3	-1.2	-0.5	1.3	-1.3	0.7
MEMORANDUM ITEMS:							
Real GDP growth	5.2	4.7	3.7	2.2	0.7	-1.1	2.0
Output gap (e)	0.5	1.2	1.6	1.5	0.5	-1.9	-1.5

Sources: Ministerio de Economía y Hacienda, Banco de España and own calculation.

(a) Net lending (+) or net borrowing (-).

(b) A plus sign denotes a contractionary stance.

(c) A plus sign denotes an expansionary stance.

(d) Net lending (+) or net borrowing (-), excluding interest payments.

(e) Output gap = (GDP - potential GDP)/GDP (%) in real terms.

cy resumed the contractionary path embarked upon in 1992, although efforts fell far short of those in 1992: despite a notably higher rate of economic growth, the budget deficit was reduced by a similar amount.

If we examine the fiscal impulse associated with the primary deficit (i.e. excluding interest payments, which depend on previous years' fiscal policy and not that of the current year), the result is similar. Taking into account the correction in 1989 and 1990, fiscal policy remained expansionary throughout the period considered, except in 1992 and 1994. Moreover, the fiscal impulse estimated for the primary deficit clearly reveals the change in the fiscal policy stance in 1993, marked by an undeniably more expansionary impulse than in the other years in question.

Another feature of fiscal policy is reflected in the breakdown of fiscal impulse into its revenue and expenditure components. If the effects of the transfer of personal income tax refunds from 1989 to 1990 are stripped out, revenue is seen to have a permanently contractionary impact between 1989 and 1992. Notably, in 1992 the impact of personal income tax reforms was more than offset by the rise in indirect taxes and, therefore, the contractionary impulse of revenue was second only to that of 1989 (when, moreover, the year's result was due to the aforementioned transfer of tax refunds). In 1993 the neutral behaviour of revenue is at-

tributable not so much to measures involving tax cuts as to certain distortions that the elimination of intra-Community customs introduced into VAT takings; this effect was automatic in that it obviously bore no relation to the business cycle, nor did it reflect a fiscal policy decision taken by the authorities. This generally contractionary contribution of government revenue, not only in recent years but also historically, underwent a change in 1994: yet even then the incidence of a non-discretionary factor – the Banco de España's return to normal profit levels – played a key role.

Throughout the years in question, the main characteristic of expenditure was its expansionary impulse, a tendency that became more pronounced as from 1988. In addition to the change in the stance of fiscal policy in 1993, there was another feature that was initially hidden in the budget balance: the discretionary increase in government spending as from 1989. Even in a year as clearly contractionary as 1992, the expansionary component in expenditure was greater than in 1988. This expansionary tendency in public spending was curbed in 1994, although the year's restrictive efforts can be judged insufficient, taking into account the powerful impulse of a discretionary nature to government expenditure in 1993.

In short, the indicator of fiscal policy stance confirms that, in the period in question, and with the exception of 1992 and 1994, fiscal policy exerted a systematically expansionary impulse that tended to exacerbate inflationary tensions during the cycle's upturn but apparently failed to mitigate the rate of decline in activity during the recession. The ultimate source of this fiscal policy stance was the process of expansionary expenditure that began in 1989 and whose impact on the structural deficit could not be offset by the contractionary measures taken on the revenue side. Against this backdrop, the effect of the business cycle (positive from 1988 to 1990, neutral in 1991, negative in 1992 and even more negative in 1993) determined the behaviour of the budget balance: stabilisation from 1988 to 1990, and increasing deterioration from 1991 onwards. In 1994, coinciding with the start of a fresh stage of economic recovery, the structural deficit was reduced very slightly, remaining at notably high levels. Within this medium-term stance, two years stand out as exceptional: 1992, when the tendency to overrun the deficit was checked, and 1993, when the budget deficit was clearly overshot. These abrupt changes in fiscal policy from one year to the next underscore the need to analyse medium-term trends – thereby cancelling out short-term distortions – and also the advisability of subjecting fiscal policy to medium-term objectives, within the framework of a comprehensive and coherent economic programme.

So far the indicator referring to the whole of general government has been applied. But it would also be worthwhile analysing separately the

contractionary or expansionary nature of the fiscal policy of general government agents. However, before discussing the results by agent, which are shown in Table II.2, several observations are in order. First, trends in activity have a greater effect on central government than on territorial governments, primarily because of the financing structure of the autonomous communities (regional governments) (2). In short, the fiscal impulse of the autonomous communities tends to overestimate the discretionary component of their fiscal policy in boom years – and, thus, these territorial agents seem to exert a more expansionary impulse – and to underestimate this component during recession. Second, the construction of this indicator for each agent does not allow us to obtain the same indicator for the whole of general government via the sum of the indicators of its individual agents, due to the asymmetric computation of the discretionary component in revenue and expenditure. Accordingly, the results of this indicator by agent should be interpreted with caution and should, in any event, be viewed more from a qualitative than from a quantitative standpoint. Lastly, as already noted, the problems of the whole of general government are eventually reflected in the State deficit. In sum, the analysis by agent introduces a bias against the State in the figures for central government by exaggerating the expansionary impact of its fiscal policy.

In any case, even taking these considerations into account, the results of the analysis of the fiscal impulse of general government agents are still interesting. The findings confirm that, from 1988 to 1991, the fiscal expansion of both territorial and central governments was similar. Between 1992 and 1994, territorial governments restrained their fiscal policy, whereas central government agents, after a contractionary policy in 1992, returned to a very expansionary policy in 1993, which they corrected somewhat in 1994 through slightly contractionary measures. A general interpretation of the evidence in Table II.2 allows us to conclude that, just as territorial governments – and, specifically, autonomous communities – were the co-protagonists of fiscal expansion from 1988 to 1991, their behaviour in the three subsequent years was contractionary. In 1993 this behaviour stands in contrast to the expansionary stance of the State. As noted earlier, the problems of the whole of general government are eventually reflected in the State budget. In this respect, the autonomous com-

(2) Specifically, we refer to financing via transfers from the State and to the fact that most transfers (those related to participation in State revenue) are subject to a ceiling (the nominal GDP growth rate) and a minimum (growth in what are known as equivalent State expenses). Thus, during recession, part of the revenue of autonomous communities grows at the rate of public spending at the State level, and, in expansionary periods, when growth in State revenue surpasses that of GDP because of the higher-than-unity elasticity of takings, their revenue grows at the same rate as GDP. This indicates that their revenue is less dependent on the economic cycle, and, since unemployment payments are outside their sphere of responsibilities, their deficit is less sensitive to the cycle.

TABLE II.2

FISCAL IMPULSE INDICATOR (IMF) (a)
GENERAL GOVERNMENT LEVELS
% of GDP

	<i>General government</i>			<i>Central government</i>			<i>Territorial governments</i>			<i>Autonomous Communities</i>			<i>Local governments</i>		
	<i>Def. (b)</i>	<i>Def. change</i>	<i>Fisc. imp.</i>	<i>Def. (b)</i>	<i>Def. change</i>	<i>Fisc. imp.</i>	<i>Def. (b)</i>	<i>Def. change</i>	<i>Fisc. imp.</i>	<i>Def. (b)</i>	<i>Def. change</i>	<i>Fisc. imp.</i>	<i>Def. (b)</i>	<i>Def. change</i>	<i>Fisc. imp.</i>
1988	-3.3	-0.1	-0.4	-2.9	0.2	-0.0	-0.3	-0.4	-0.4	-0.3	-0.3	-0.4	-0.0	-0.0	-0.1
1989	-2.8	0.5	0.2	-2.0	0.9	0.7	-0.8	-0.5	-0.6	-0.6	-0.3	-0.3	-0.2	-0.2	-0.2
1990	-4.1	-1.3	-1.5	-3.1	-1.1	-1.3	-1.0	-0.2	-0.3	-0.8	-0.2	-0.2	-0.2	0.0	-0.0
1991	-4.9	-0.8	-0.7	-3.3	-0.2	-0.1	-1.6	-0.6	-0.6	-1.4	-0.6	-0.6	-0.2	-0.0	-0.0
1992	-4.2	0.7	1.1	-3.0	0.3	0.6	-1.2	0.4	0.5	-1.0	0.4	0.5	-0.2	0.0	0.1
1993	-7.5	-3.3	-2.3	-6.2	-3.2	-2.3	-1.3	-0.1	0.1	-1.1	-0.1	0.0	-0.2	0.0	0.2
1994	-6.7	0.8	0.7	-5.6	0.6	0.5	-1.1	0.2	0.2	-1.0	0.2	0.2	-0.1	0.0	0.0

Sources: Ministerio de Economía y Hacienda, Banco de España and own calculation.

(a) A plus sign denotes a contractionary stance.

(b) Net lending (+) or net borrowing (-).

munities' moderate behaviour in 1993 contrasts with the surge in State transfers to these agents.

The analysis using fiscal impulse as a starting point has so far focused on the medium-term trends in fiscal policy from 1988 to 1993. However, it would also be interesting to study the changes in fiscal policy in the very short run to ascertain whether fiscal policy has a stabilising effect in the short run or whether, on the contrary, it is characterised by high volatility, with the potential for distortion that this would represent. To analyse this possibility, a quarterly indicator of fiscal policy stance was prepared from the cash-basis data of the State budget (excluding interest payments due to their strong volatility), whose findings are given in Table II.3.

After analysing the figures in Table II.3, our main conclusion is that the pattern of behaviour of fiscal policy was very volatile over the course of each year and also differed sharply from one year to another. Thus, in 1988 the expansionary impact of fiscal policy mainly occurred in the third quarter, whereas in 1989 fiscal policy was expansionary in the first half of the year and contractionary in the second half. In 1990 the third quarter was again the most expansionary, while 1991 witnessed an abrupt swing from a very contractionary third quarter to a very expansionary fourth quarter. In 1992 and to an even greater degree in 1993, fiscal policy was increasingly expansionary, more as a result of trends in expenditure than in revenue. In 1994 fiscal policy made its most clearly contractionary contribution in the final quarter, based on expenditure control. The contribu-

tions of both expenditure and revenue were highly volatile, as reflected in their variation coefficient, albeit much lower than that of the balance. As to the cyclical effect, it provides a perfect reflection of the increasing impact of the slowdown in activity on the budget deficit, peaking in the second quarter of 1993.

From the analysis of the quarterly indicator, the following conclusions can be drawn: first, the stance of fiscal policy has been considerably volatile over the course of each year; second, this volatility is explained by trends in both revenue and expenditure; third, this strong volatility may have had a highly distorting impact; lastly, fiscal policy, due to the volatility in its stance, undoubtedly heightened economic agents' uncertainty, since the signals emitted were difficult to interpret in terms of the future course of fiscal policy.

To summarise, in this chapter, the stance of fiscal policy – its contractionary or expansionary nature – from 1988 to 1994 has been analysed by constructing composite indicators. It arrives at the following conclusions:

- In the period in question, fiscal policy has been characterised by an expansionary stance that tended to exacerbate the imbalances in the economy during the boom years of the cycle. The first year that was marked by contractionary behaviour in fiscal policy (1992) was followed by a year of strong expansion, reflecting a shift in fiscal policy priorities due to the recession. This expansionary impulse was corrected slightly in 1994, as a fresh upturn in the business cycle began.
- The disaggregated analysis of revenue and expenditure confirms the expansionary nature of spending from 1988 to 1993, which fiscal contraction on the revenue side failed to offset.
- In terms of agents, the expansionary policy in the period 1988-1991 and the contractionary policy in 1992 were not only driven by central government but also by territorial governments. Nonetheless, the fiscal expansion in 1993 was driven by central government, since the behaviour of territorial governments was slightly contractionary. However, this characteristic of 1993 should be interpreted with caution, in view of the intense growth in transfers from the State to autonomous communities during the year. In 1994 the fiscal policy stance of both types of agent was moderately contractionary.

TABLE II.3

FISCAL IMPULSE INDICATOR (IMF). STATE (a)
% of quarterly GDP

	<i>Primary balance</i>	<i>Change in primary balance (b)</i>	<i>Primary fiscal impulse (b) (c)</i>	<i>Fiscal impulse revenue (b) (c)</i>	<i>Fiscal impulse expenditure (b) (d)</i>	<i>Cyclical effect (b)</i>	<i>GAP (e)</i>
1988-I	-0.6	1.5	1.3	0.1	-1.2	0.3	0.5
1988-II	0.9	3.3	3.1	3.6	0.5	0.2	0.7
1988-III	0.5	-1.7	-1.8	-1.3	0.4	0.1	0.6
1988-IV	-0.8	0.5	0.4	-0.9	-1.3	0.1	0.7
1989-I	-2.4	-1.8	-1.9	0.0	1.9	0.1	0.9
1989-II	-1.5	-2.3	-2.5	-2.7	-0.2	0.1	1.2
1989-III	2.8	2.3	2.2	3.3	1.1	0.2	1.5
1989-IV	5.3	6.1	5.9	4.9	-1.0	0.2	1.7
1990-I	-0.0	2.3	2.1	-0.6	-2.7	0.2	1.8
1990-II	0.5	2.0	1.9	1.8	-0.1	0.1	1.8
1990-III	-3.2	-6.0	-6.1	-5.7	0.4	0.1	1.8
1990-IV	4.7	-0.7	-0.7	1.3	2.0	0.0	1.8
1991-I	-0.6	-0.6	-0.5	1.1	1.7	-0.0	1.7
1991-II	-0.6	-1.1	-1.0	0.9	1.9	-0.0	1.6
1991-III	3.4	6.6	6.6	4.1	-2.6	-0.0	1.7
1991-IV	-0.6	-5.3	-5.3	-5.4	-0.1	-0.0	1.7
1992-I	-2.7	-2.1	-2.1	-0.8	1.3	-0.0	1.6
1992-II	-1.1	-0.6	-0.5	-0.5	0.0	-0.1	1.2
1992-III	1.3	-2.1	-1.9	-1.1	0.8	-0.2	0.5
1992-IV	3.3	4.0	4.4	3.7	-0.6	-0.4	-0.5
1993-I	-1.0	1.6	2.2	0.6	-1.6	-0.5	-1.2
1993-II	-2.2	-1.1	-0.5	0.5	1.0	-0.6	-1.8
1993-III	-2.6	-3.9	-3.4	-1.7	1.7	-0.5	-2.1
1993-IV	-3.1	-6.4	-6.1	0.5	6.6	-0.3	-2.1
1994-I	0.9	2.0	2.0	2.1	0.1	-0.1	-1.7
1994-II	-2.3	-0.1	-0.2	-0.7	-0.6	0.1	-1.4
1994-III	-1.6	1.0	0.8	-0.6	-1.4	0.2	-1.1
1994-IV	-0.6	2.4	2.2	-3.8	-5.9	0.2	-0.8
MEMORANDUM ITEM:							
V.C. (f)			100.9	24.2	28.5		

Sources: Ministerio de Economía y Hacienda, Banco de España and own calculation.

- (a) In cash-basis terms.
(b) Year-on-year change.
(c) A plus sign denotes a contractionary stance.
(d) A plus sign denotes an expansionary stance.
(e) $GAP = (GDP - \text{potential GDP})/GDP$ (%) in real terms.
(f) Variation coefficient = Standard deviation/mean.

- Lastly, the analysis confirms the high volatility in the stance of fiscal policy, on both the revenue and expenditure sides. Such volatility may have had highly distorting effects because of its adverse impact on economic agents' uncertainty.

III

THE MACROECONOMIC IMPACT OF FISCAL POLICY

Fiscal policy exerts either a moderating or expansionary effect on the aggregate demand of the economy. And depending on the degree of flexibility or rigidity of supply, capacity utilisation, etc., this pressure will feed through partly to real growth and partly to prices. As it is difficult to distinguish between the impact on prices and the real impact, since this would require a complex analysis of the effects of fiscal policy or a significantly subjective value judgment, this dimension of the problem is not addressed in the present chapter. Here our analysis will simply point out the existence of possible inflationary pressures – measured in terms of the growth in public spending and effective general government demand – and, with a descriptive approach, offer several general observations on the potential impact of these pressures on price trends.

Another aspect that must be considered is the incidence that fiscal policy may have on the economy's external imbalance, both directly (via the impact of the budget deficit on the nation's net borrowing) and indirectly (via the effect of fiscal policy on competitiveness). Here again, the purpose is not to discern, for example, whether the twin-deficit hypothesis holds in the Spanish case, but rather to make several general observations on the possible impact of fiscal policy on the current-account balance. In particular, it would be interesting to know whether the apparent lack of any connection between the current-account deficit and the budget deficit in 1993 – when, despite a considerable increase in the budget deficit, the balance on current account moved close to equilibrium – is a feature that could persist in subsequent years or whether, on the contrary, the process of economic recovery entails an increasing impact of the budget deficit on the current-account deficit.

One final aspect of fiscal policy at the macroeconomic level is its credibility, i.e. the effect that the uncertainty generated by fiscal policy, via the expected behaviour of expenditure and taxes, may have on the behaviour of economic agents. Among other features, Spanish fiscal policy

is characterised by systematic deviations from forecasts that are only partly attributable to the uncertainty surrounding the course of economic activity. In this respect, the deterioration in the implementation of fiscal policy in the years in question is clearly evidenced first in the Convergence Programme of mid-1992, conditioned by notably optimistic forecasts of the economy's real growth; and further, in the State budget for 1993, when the budget deficit, at 5.6 % of GDP, more than doubled the initial forecast of 2.3 % of GDP. The fact that, in both cases, the intensity of the recession was greater than initially forecast does not in itself explain the failure to fulfil the fiscal policy objectives in the first Convergence Programme or to meet the State budget objectives in 1993.

In short, this chapter will discuss, in a succinct and summary fashion, the macroeconomic impact of fiscal policy. It will specifically address how fiscal policy influences inflation, the current-account deficit and economic agents' uncertainty.

III.1. Fiscal policy and inflation

Chapter I examined the expansionary nature of fiscal policy in the years 1988 to 1994 (with the exception of 1992 and 1994) and how public spending acted as the single driving force behind this expansionary behaviour. But this general description of fiscal policy in the period in question actually covers two very different sub-periods, one marked by very robust economic growth in the years 1988, 1989 and 1990, and another reflecting the increasing slowdown in the economy that culminated in the deep-seated recession of 1993 and the subsequent recovery during 1994. At the macroeconomic level, the impact of the expansionary impulse of fiscal policy may have differed in each of these sub-periods.

In this respect, the main problem created by the expansionary nature of fiscal policy in the boom period was that it led to an unbalanced monetary/fiscal policy mix. Indeed, due to the expansionary and pro-cyclical nature of fiscal policy, monetary policy had to act almost single-handedly to contain the inflationary pressures generated by the buoyancy of economic growth; and this, coupled with the significant structural rigidities in the Spanish economy and the absence of a sufficiently energetic reform policy to combat them, exacted a very high price in terms of efficiency. Thus, this policy mix had a greater impact on tradeable goods (precisely the least inflationary sector) than on non-tradeable goods (the most inflationary sector, due to the greater market power derived from the lack of foreign competition and scant competition at home). This resulted in problems of dual inflation and a lack of competitiveness and also led to a

PUBLIC SPENDING AND AGGREGATE DEMAND (a)

Sources: Ministerio de Economía y Hacienda and Banco de España.

- (a) Percentage change.
- (b) Current prices.

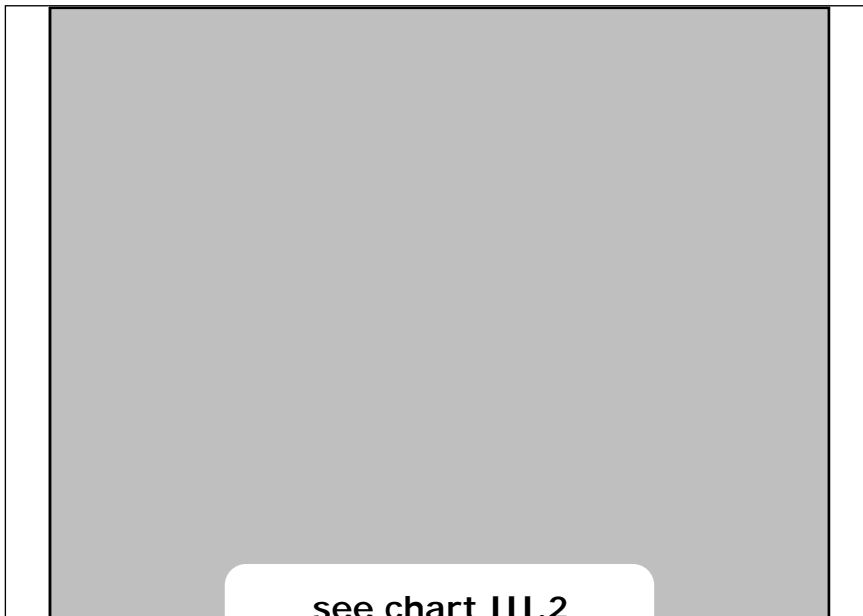
redistribution in favour of the more inflationary productive sectors, with lower productivity gains and, by extension, less growth potential.

After the period of intense economic growth and the onset of a substantial slowdown in activity, the lack of a correction in the structural deficit – which had, in fact, increased during the boom period, coinciding with the growing budget deficit of a cyclical nature – began to have direct consequences on the medium-term sustainability of the fiscal policy stance then in place. Thus, apart from the aforementioned impact on dual inflation and the external sector, in itself the growth in the public debt/GDP ratio in preceding years made it essential to effect a far-reaching and rapid correction in the structural deficit (1).

This chapter provides a descriptive analysis of the inflationary pressures that fiscal policy may have exerted in recent years. One characteristic feature that can be deduced from the growth rates in public spending

(1) For a more detailed analysis of the problem of the sustainability of public debt, see González-Páramo, Roldán and Sebastián (1992).

**EFFECTIVE GENERAL GOVERNMENT DEMAND
AND AGGREGATE DEMAND (a)**



Sources: Ministerio de Economía y Hacienda and Banco de España.

- (a) Percentage change.
- (b) Current prices.
- (c) Net purchases plus public investment.

and national demand since 1976 (Chart III.1) is that growth in expenditure was systematically higher (except in the three-year period 1986-1988 and in 1994) than that in demand. From a long-term perspective, public spending has undoubtedly exerted pressure on supply, which possibly had an upward impact on prices.

Insofar as the bulk of public spending consists of transfers to households and firms, financed from taxes in turn imposed on (other) households and firms, the potentially inflationary effects of this intense growth in expenditure will depend on the characteristics of the income redistribution induced by public spending. Thus, in general, the greater the redistribution effect, the greater the potential impact of this spending increase on inflation. Accordingly, if lower-income households show a higher marginal propensity to consume, or are subject to liquidity constraints, this income redistribution induced by public spending and taxes will increase private consumption and domestic demand, affecting via this channel the level of prices in the economy. But, in addition to this channel of indirect pressure on supply (through the effect of expenditure on demand), there is a direct

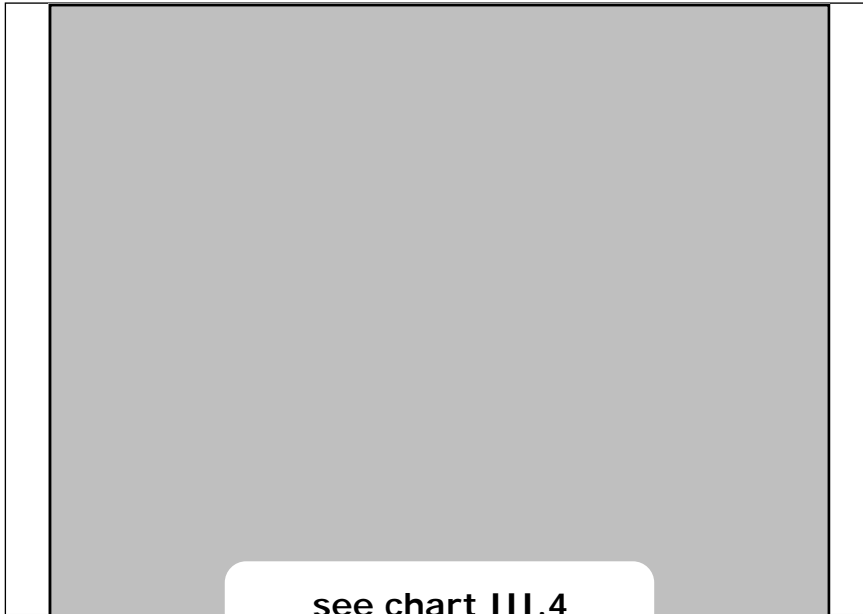
PUBLIC SPENDING AND INFLATION

Sources: Ministerio de Economía y Hacienda and Banco de España.

- (a) Percentage change.
- (b) Measured by the national demand deflator.

channel derived from the pressure that effective general government demand exerts on supply (2). As shown in Chart III.2, in just seven years, from 1976, did the growth in effective demand fall short of that of nominal demand. The most significant year was 1992, when effective general government demand did, in fact, decline, thus confirming the contraction in fiscal policy that year. In 1994 effective demand also registered a negative growth rate, but the cause could largely lie in the previous year's overrun in expenditure. Likewise, the high growth in effective general government demand in 1989, 1990 and 1991 and particularly in 1993 illustrates the expansionary nature of fiscal policy in these years. In principle, the potential inflationary impact of the growth in effective general government demand, which depends on the rigidities in aggregate supply (in turn a determinant in the distribution of this demand between volume and price), should be small, given the scant volume of this demand in re-

(2) Effective general government demand is defined as final demand, not including compensation of employees and consumption of fixed capital, i.e. public investment plus net purchases. The reason for eliminating these two components is that, under accounting convention, they coincide exactly with the value added of general government.

FISCAL POLICY STANCE AND INFLATION

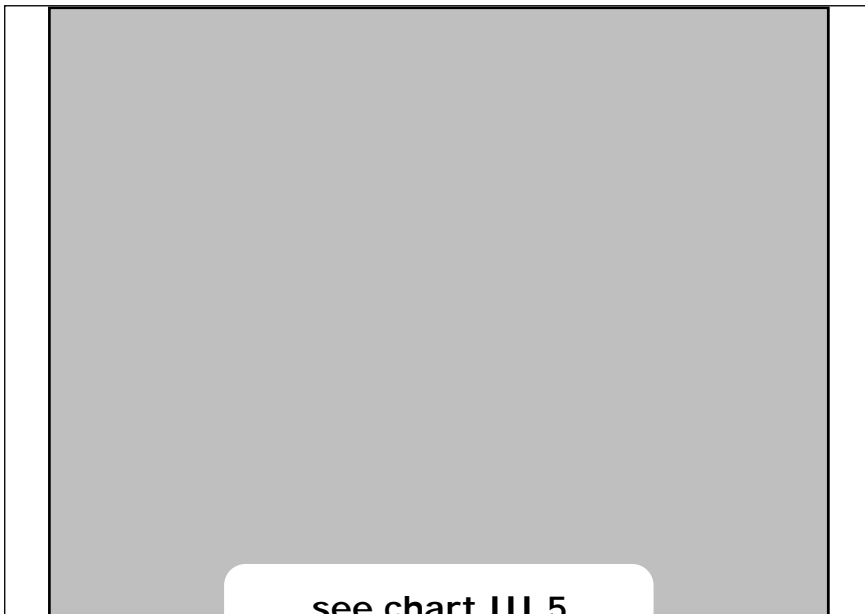
Sources: Ministerio de Economía y Hacienda and Banco de España.

- (a) A plus sign denotes an expansionary stance. Data for 1989 and 1990 adjusted for the delay in personal income tax refunds..
- (b) Measured by the national demand deflator.

lation to aggregate demand. However, there are several reasons why this inflationary impact may not have been negligible. For one thing, inflationary pressure persisted over time: in only seven of the past 19 years was effective general government demand lower than the growth in demand, and this growth was negative in only two years. For another, in many years this growth was roughly twice that of national demand; hence, despite the small volume of effective general government demand in relation to total demand, its inflationary impact may have been greater than what its scant volume would, in principle, have dictated. Lastly, it must be borne in mind that a large part of this inflationary pressure acts precisely in a sector of the economy (namely that of non-tradeable goods) characterised by supply rigidities. As a result, it is likely to generate a very scant or nil increase in real supply, primarily affecting prices in the sectors sheltered from external competition that absorb this effective demand.

Admittedly, a more detailed analysis is evidently necessary before final conclusions can be reached on the inflationary impact of fiscal policy. However, the patterns of the growth in expenditure (Chart III.3), the

EFFECTIVE GENERAL GOVERNMENT DEMAND AND INFLATION



Sources: Ministerio de Economía y Hacienda and Banco de España.

- (a) Net purchases plus public investment, percentage change.
- (b) Measured by the national demand deflator.

stance of fiscal policy – fiscal impulse (Chart III.4) – and the growth in effective general government demand (Chart III.5) are, on several counts, similar to the inflation pattern. Specifically, the rise in inflation in the period 1989-1991 coincides with the increase in the growth in public spending and effective demand and also with a more expansionary fiscal policy.

To summarise, from this descriptive approach we can deduce that fiscal policy probably had a considerable inflationary impact. Thus, almost without exception, over the past 20 years the growth in public spending and in effective general government demand has outpaced the growth in demand. In addition to this pressure on prices via public spending, the inefficient provision of certain public services generated further inflationary effects.

III.2. Fiscal policy and the external sector

A simplistic view of the relationship between the budget deficit and the current-account deficit, such as that taken from a strictly accounting

perspective, may prove inappropriate. In 1993, for instance, the budget deficit rose from 4.2 % of GDP to 7.5 %, but did not prevent the current-account deficit – the nation's net borrowing – from falling to 0.4 % of GDP from 3 % of GDP. Conversely, the reduction in the budget deficit in 1994 by 0.8 points of GDP was accompanied by an increase in the current-account deficit, which climbed to 0.7 % of GDP.

Indeed, the available evidence (3) seems to confirm that, in the past, higher budget deficits have not generated higher current-account deficits. The balance on current account appears to have oscillated around equilibrium over the past 30 years, whereas the budget deficit fluctuated greatly in the same period. This empirical evidence, coupled with the findings for 1993 and 1994, would suggest that the potential impact of fiscal policy on the current-account deficit is minimal.

It would be a great mistake, however, to conclude that fiscal policy does not affect the external imbalance. The evidence for 1993 is relatively insignificant, because the movements in the budget and external imbalances are the product of a third element not taken into consideration: the recession. In effect, a recession has a negative impact on the budget imbalance – the result of the automatic stabilisers at play – and a positive impact on the external sector – with imports affected by the fall in demand, but not necessarily exports (4). Thus, the outcome for 1993 is a short-term result directly linked to the recession and unsustainable in the long run. Similarly, the movements in both imbalances in 1994 were influenced by the recovery in the economy that year.

Chart III.6 clearly illustrates this impact of the business cycle. The movements in the current-account deficit/budget deficit relationship from 1989 to 1992 for OECD countries as a whole do not seem to coincide with the accounting identity (dotted line), according to which the increases in the budget deficit would lead to movements of a similar volume and sign in the current-account deficit. In fact, these movements are contrary to the accounting forecast – perpendicular to the dotted line – because, in general, there is a worsening in the budget deficit but an improvement in the current-account balance. Nonetheless, as noted, these movements should not be interpreted as evidence of the irrelevance of budgetary policy in determining the current-account balance, since they are the product of the recession's impact on both balances. Indeed, the only country where this movement seems to coincide with the dotted line is Germany,

(3) For an analysis of the inter-relatedness of the private- and public-sector deficits and the current-account deficit within the EU, see Argimón and Roldán (1994).

(4) In fact, the contraction in the domestic market can have a positive impact on exports, since part of production is re-routed to markets abroad.

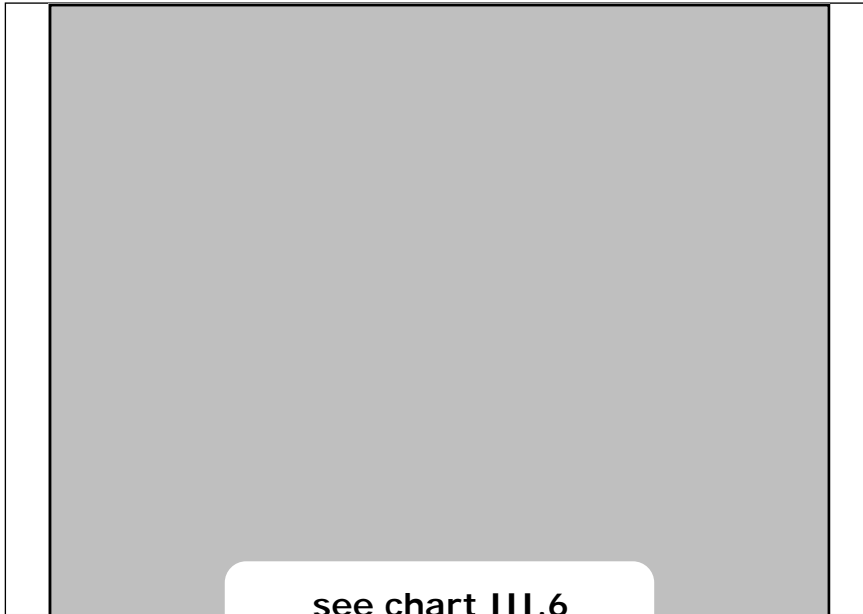
which suffered not only the cyclical shock affecting the other countries but also a structural shock caused by reunification. In short, the findings for Spain in 1993 and 1994 (and for the rest of the OECD countries from 1989 to 1993) are influenced by short-term cyclical elements and cannot, therefore, be considered to disprove the existence of a long-term relationship between the budget deficit and the current-account deficit.

Moreover, several important transformations in recent years must also be borne in mind. Specifically, the full liberalisation of capital movement in 1991 along with Spain's entry into the Exchange Rate Mechanism (ERM) in 1989 (i.e. the shift to a fixed exchange-rate system) shaped a different framework from that of the past. With free capital movements, a fixed exchange rate and the increasing substitutability of national and foreign assets, fiscal policy became a stronger force in solving current-account balance problems. Indeed, this is what the available empirical evidence appears to demonstrate (5): in countries where there is free movement of capital, changes in the budget deficit are associated, in the long run, with changes in the current-account balance.

Lastly, although difficult to quantify, the possible impact on the competitiveness of the Spanish economy produced by the expansionary fiscal policy implemented since 1989 must also be taken into account. In this respect, expansionary fiscal policy forced monetary policy to play a greater role in combating inflationary pressures (rekindled, in turn, by fiscal policy), and this ultimately had adverse effects on sectors exposed to external competition (more dynamic and less inflationary), while the sheltered sectors (more inflationary) were not affected to the same degree. In short, this imbalance in policy mix affected the competitiveness of the Spanish economy and, via this channel, the external deficit.

To summarise, the scant correlation observed between the budget deficit and the current-account deficit (in Spain particularly in 1993, and in the OECD in recent years) should not lead us to underestimate the impact of fiscal policy on the current-account deficit and competitiveness. The recent recession could, in fact, have hidden the effects that the fiscal stance (expansionary since 1989) and the widening of the budget shortfall could have had on the current-account deficit and the competitiveness of the Spanish economy. The economic upturn, the recovery in private consumption, productive and residential investment and the resulting decline in the private sector's net lending may all highlight these potential effects of fiscal policy on the structural external deficit.

(5) See Argimón and Roldán (1994).

BUDGET AND CURRENT-ACCOUNT BALANCES

Source: OECD Economic Outlook 54.

III.3. Fiscal policy credibility and economic agents' uncertainty

The credibility of fiscal policy and of economic policy in general is crucial to policy effectiveness. Thus, fiscal policy has greater room for manoeuvre if, for example, it can use the announcement of measures as an instrument of economic policy. If, conversely, it lacks sufficient credibility, this “announcement effect” cannot be used, and the effectiveness of fiscal policy is diminished.

But insufficient credibility also signifies a loss of efficiency insofar as the degree of uncertainty of economic agents increases. If fiscal policy is a source of uncertainty, this greater uncertainty will hamper the economic estimates on which economic agents' intertemporal decisions are based. Also, and in particular, it will have adverse effects on the stability and level of private investment, potential output and employment. Stability will be affected because uncertainty generates the avoidable fluctuations in investment decisions that are associated with changes in information concerning the influence of fiscal policy on aggregate demand. Investment levels will be affected because of the resulting postponement of certain investment projects (since the decision not to invest until the uncertainty is dispelled can, in some cases, result in higher profitability than that gen-

erated by an immediate investment) and the rise in real interest rates (due to higher risk premia). If, by contrast, fiscal policy is credible and is accompanied by plans spanning several years with precise, clear and observable objectives, then it can benefit economic activity by diminishing the uncertainty in the economic setting in which agents operate.

Problems of credibility have been attributed to fiscal policy in Spain. It is argued that fiscal consolidation plans spanning several years (such as the first Convergence Programme) have proved impossible to implement only a few months after being announced and that State budgets have not been met, not only with respect to the volume of the deficit, revenue and expenditure, but also with respect to their composition. Lastly, the lack of credibility is also attributed to the legislative measures that shape the fiscal and legal framework in which firms and economic agents operate. This framework has been seen to change from one year to another, in some cases in a contradictory fashion, cases in point being the reform and subsequent counter-reform of personal income tax laws in 1992, and the extension of unemployment benefits in 1989 and their subsequent reduction in 1992.

In 1993 these problems grew particularly acute. Compared with a State deficit forecast of PTA 1,432 billion, the final result (in terms of committed expenditure and receipts pending collection) was PTA 3,396 billion, more than triple the previous year's deficit (PTA 1,066.3 billion). This behaviour is due not only to the year's moderate advance in revenue (up 2 %, compared with a forecast of 3 %) but also, above all, to the strong deviation in expenditure (up 18.5 %, compared with a forecast of 5.4 %). Even the breakdown of revenue and expenditure differed from initial projections. On the revenue side, tax takings declined and extraordinary income, such as revenue from profits and dividends, increased. And on the expenditure side, there was an overrun in all items except personnel costs and financial expenses. Briefly stated, the 1993 budget outturn not only signified a change in the stance of fiscal policy but also meant a loss of confidence in the initial budget as an instrument for forecasting the year's public spending and revenue.

It can be argued that these deviations in 1993 were the product of the unexpected recession or of its extraordinary depth. As a result, in preparing the year's budget, the projected growth in activity was higher than it actually turned out to be. In sum, the cyclical sensitivity of the budget, coupled with the uncommon depth of the recession, would explain the scale of the budget's deviations in 1993 (or in other years).

Yet though the factors adduced certainly clarify part of the developments that year, there are other elements pointing towards more deeply rooted causes for these deviations. First, from the perspective of the recent past, the budget outturn in 1993 was not unusual. As shown in Chart

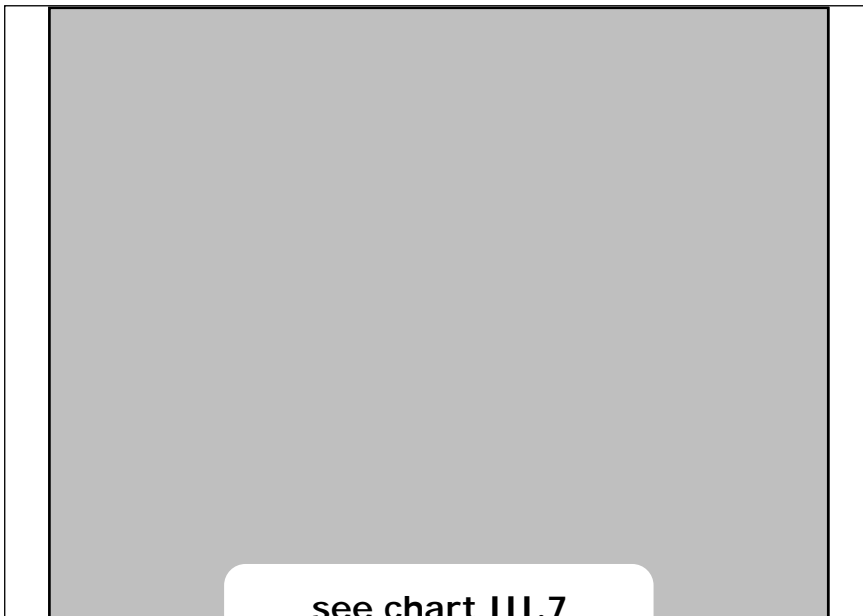
III.7, which reflects the nominal growth in expenditure in each budget (initial appropriations) and the resulting growth in the budget outturn (defined in terms of committed spending), growth forecasts were systematically lower than the actual outturn, with the – not fortuitous – exception of 1983 and 1984. This pattern of recurrent deviations can only occur if the State budget for expenditure, far from representing a rigid constraint, is flexible, highly adaptable and, by extension, hardly effective in capping growth in spending. Although unexpected changes can arise in the macroeconomic setting that can directly affect public spending, via unemployment benefits, for example, it is difficult to explain such a persistent pattern of deviations over an entire business cycle in terms of these surprises.

The uncertainty associated with the course of the business cycle does not appear to explain the failure to meet the budget. Table III.1 gives the estimates for the credibility gap of the State budget. This gap is defined simply as the difference between the actual budget outturn for revenue and expenditure (in terms of committed expenditure and recognised receipts) and that envisaged in the initial budget projection. Thus, a minus sign in the gap denotes a credibility problem in fiscal policy. In turn, this credibility gap is calculated for revenue and expenditure adjusted for the cyclical effect, i.e. in terms of fiscal impulse. This provides for an evaluation of whether the credibility problem ultimately stems from the *surprises* over developments in the business cycle. In addition, a disaggregated calculation of this gap is made for revenue, expenditure and their respective captions.

As shown in Table III.1, the comparison between the deficit gap (the change therein) and the fiscal impulse gap does not lend support to the interpretation that the business cycle is the explanatory factor in budget deviations. Indeed, a large part of the observed deviation persists when adjustment is made for the effect of the cycle (which is reflected in the fiscal impulse) and, therefore, the uncertainty over future developments in activity does not seem to be the source of the problem of fiscal policy credibility. Here again, it is important to take into account that the figures for 1989 and 1990 are distorted by the transfer of refunds relating to excess personal income tax paid in 1988 from 1989 to 1990, creating an upward bias in the contractionary nature of the 1989 budget outturn vis-à-vis its initial projection.

Another characteristic feature is that the budget outturn as from 1990 was, with the exception of 1992, systematically more expansionary than initially forecast, as reflected in the minus sign in the credibility gap calculated in terms of fiscal impulse. Looking at the breakdown between expenditure and revenue, another key element in this problem emerges: whereas the final results for revenue were generally more contractionary than intended in the initial budget (with the exception of 1990, due to the distortion produced by personal income tax refunds), the results for ex-

**STATE BUDGET
INITIAL APPROPRIATIONS AND COMMITTED EXPENDITURE**



Source: Ministerio de Economía y Hacienda.

(a) Growth rate in relation to the previous year's committed expenditure.

penditure were, without exception, more expansionary. These same features, though less pronounced, persisted in the 1994 budget outturn, since the absence of any significant deviations was largely due to the fact that the economic backdrop was more favourable than forecast when the budget was being prepared. The year 1993 deserves special mention, since it witnessed a most notable deviation in the State budget that was attributed to the unexpected intensity of the recession. However, an analysis of Table III.1 seems to rule out this explanation, suggesting instead the hypothesis of a change in the fiscal policy stance during the year: most of the deviation is explained by the discretionary action reflected in the estimated fiscal impulse. Moreover, even if this indicator failed to adjust the deficit properly for the effect of the cycle, this unexpected cyclical effect would be incapable of causing deviations in all expenditure components, from expenses for goods and services to real investment.

In examining the disaggregation of expenditure in its assorted components, it can be seen that not all captions were equally expansionary in the budget outturn. In particular, whereas the investment outturn was usually more contractionary than budgeted (except in 1991 and 1993),

TABLE III.1

CREDIBILITY GAP: STATE (a)

	1988	1989	1990	1991	1992 (b)	1993	1994
CHANGE IN							
BUDGET BALANCE	0.57	1.80	-0.59	-0.64	0.16	-3.96	0.00
FISCAL IMPULSE (c)	0.35	1.51	-0.53	-0.44	0.69	-3.56	-0.13
Fiscal impulse of revenue (c) ..	1.00	1.56	-0.35	0.12	0.85	0.25	0.04
Fiscal impulse of expenditure (d) ..	0.65	0.04	0.17	0.56	0.16	3.82	0.17
Personnel costs	-0.12	-0.21	0.03	0.08	-0.08	0.21	0.07
Purchases of current goods and services.....	0.06	0.00	0.01	-0.01	0.00	0.17	-0.01
Financial expenses	0.37	0.24	0.03	0.42	-0.09	0.05	-0.08
Current transfers	0.32	0.42	0.18	-0.04	0.84	2.81	0.11
<i>To Autonomous Communities</i> ..	<i>0.10</i>	<i>0.20</i>	<i>0.04</i>	<i>-0.23</i>	<i>0.48</i>	<i>0.48</i>	<i>-0.32</i>
<i>To local governments</i>	<i>-0.04</i>	<i>-0.16</i>	<i>0.06</i>	<i>0.03</i>	<i>0.02</i>	<i>0.04</i>	<i>0.16</i>
<i>To autonomous administrative agencies</i>	<i>0.24</i>	<i>0.16</i>	<i>-0.01</i>	<i>-0.03</i>	<i>0.35</i>	<i>1.53</i>	<i>-0.04</i>
<i>To Social Security</i>	<i>-0.03</i>	<i>0.18</i>	<i>0.27</i>	<i>0.26</i>	<i>-0.09</i>	<i>0.32</i>	<i>0.28</i>
<i>To autonomous commercial agencies</i>	<i>0.02</i>	<i>-0.02</i>	<i>0.01</i>	<i>-0.02</i>	<i>-0.06</i>	<i>0.02</i>	<i>0.02</i>
<i>To public-sector firms and other public institutions</i>	<i>0.10</i>	<i>0.18</i>	<i>-0.03</i>	<i>0.04</i>	<i>-0.14</i>	<i>0.32</i>	<i>0.01</i>
<i>To private-sector firms</i>	<i>-0.01</i>	<i>-0.01</i>	<i>-0.01</i>	<i>0.01</i>	<i>-0.01</i>	<i>0.00</i>	<i>-0.01</i>
<i>To households and non-profit institutions serving households</i> ..	<i>-0.01</i>	<i>-0.00</i>	<i>-0.03</i>	<i>0.04</i>	<i>0.19</i>	<i>0.03</i>	<i>0.01</i>
<i>Abroad</i>	<i>-0.10</i>	<i>-0.13</i>	<i>-0.11</i>	<i>-0.16</i>	<i>-0.07</i>	<i>-0.01</i>	<i>-0.08</i>
Real investment.....	-0.04	-0.37	-0.22	0.52	-0.45	0.25	-0.06
Capital transfers.....	0.06	-0.06	0.14	-0.42	-0.07	0.29	0.13

Sources: Ministerio de Economía y Hacienda, Banco de España and own calculation.

(a) Difference, as a percentage of GDP, between the figures for the budget outturn in terms of firm revenue and committed expenditure, less those contemplated in the initial budget.

(b) The 1991 data were adjusted to make them homogeneous with the 1992 structure (institutional change in the Tax Revenue Service and the Postal Service).

(c) A plus sign denotes a contractionary stance.

(d) A plus sign denotes an expansionary stance.

the outturn of current transfers and financial expenses was more expansionary than in the initial budget targets. Here again this feature reflects problems in the design of fiscal policy. In the case of investment, its contractionary outturn points to inter-relatedness between the political cycle and the budget: in dealing with a deviation from the deficit target, it is easier (i.e. less costly in political terms) to trim investment than to reduce, for example, entitlement spending in the area of welfare benefits. With respect to current transfers, their expansionary outturn reflects the adapt-

ability of budgetary stringency amid pressures from economic agents. The fact that, among current transfers, those assigned to autonomous communities and social security were largely responsible for the budget overrun indicates that the credibility problem of fiscal policy is not confined solely to the sphere of the State but affects the whole of general government. As to the overrun in financial expenses, this striking feature possibly reflects a technical flaw in the preparation of the budget, in that interest payments depend on the debt issued the previous year and, considering the small portion of debt securities with maturities of less than one year, they should be perfectly well known at the time of drawing up the new budget.

To summarise, the findings for budget deviations suggest that there was, at least to 1993, a credibility problem in the area of fiscal policy. The persistence of overruns over time, the systematically expansionary nature of the budget outturn (compatible with a contractionary outturn in revenue and an expansionary result in expenditure) and the magnitude of the deviations in the case of current transfers to other general government agents confirm that the origin of this credibility problem lies in the ineffectiveness of the overall budget constraint. This indicates the existence of flaws in the institutional framework, either in budget techniques or in the inadequate provision for expenses in the initial budget. There is no easy solution to such institutional problems. One possibility would be to establish rules limiting the growth in expenditure, although designing effective ones would be most complicated.

Since 1990, rules of this type have been included in Article 10 of the Budget Law, setting a ceiling on both the variation in initial appropriations (extraordinary and supplementary appropriations were not allowed to exceed a certain percentage of initial appropriations) and in expenditure commitments (these could not exceed initial appropriations, except in the case of expenditure generated by extraordinary appropriations, supplementary appropriations and prior income). However, due to the sizable difference between actual and forecast expenditure, Article 10 had to be rescinded in the 1993 budget. Although this illustrates the difficulty in defining rules with sufficient guarantees, it does not mean that such rules are, though imperfect, of no use. Their usefulness lies in the fact that they make compliance, or non-compliance, with the initial budget constraint more transparent, raising the cost of potential overruns and ensuring a stricter budget outturn in the future.

From this standpoint, Article 10 cannot be said to have failed in its mission; not even in 1993, when its applicability was overturned. In short, one lesson that can be drawn from the behaviour of budget deviations since 1976 is that the rules setting ceilings on growth in expenditure, such as those in Article 11 in the 1995 budget, are at least useful in limiting the scale of these deviations.

IV

PUBLIC DEBT, THE BUDGET DEFICIT AND MONETARY UNION

IV.1. The Maastricht Treaty and the excessive deficit criterion

The Maastricht Treaty obliges the European Council to conduct regular examinations of the state of public finances in member states, the aim being to control risks associated with an unbalanced or expansionary fiscal stance. In concrete, these examinations have been conducted since the start of the second stage of Economic and Monetary Union (EMU), i.e. since 1994; however, examinations will not be accompanied by sanctions (in the event of an excessive deficit) until the start of Monetary Union, except regarding the potential forgoing of Cohesion Funds in the case of recipient countries thereof. But what is most relevant about the excessive deficit criteria is that those countries whose public finances have not – in the terms established in these criteria – been restored to health may not join the Monetary Union.

The criteria, which are designed to establish when there is an excessive deficit, are defined in articles 104c(2) and 104c(3) of the Union Treaty and in article 1 of the Protocol on the Excessive Deficit Procedure. Outlined below, these articles establish that:

A) The Commission shall prepare a report on a member country if at least one of the following criteria is met:

— The budget deficit/GDP ratio exceeds 3 %, except if:

i) This ratio is diminishing continuously and substantially and is close to the reference value.

Or, alternatively:

ii) The excess over the reference value is exceptional and temporary, and the ratio remains close to its reference value.

- The public debt/GDP ratio exceeds 60 %, unless it declines sufficiently and draws close to its reference value at a satisfactory rate.
- If, despite compliance with the foregoing criteria, the Commission considers there is a risk of an excessive deficit in the member state..

B) The Commission will moreover take into account:

- If the budget deficit is greater than public investment.
- Other relevant factors, such as the budgetary and economic position in the medium term.

As can be seen, these criteria contain a sufficient degree of ambiguity so as to avoid the problems that might arise from the strict application of rigid and scarcely justifiable rules from a regulatory standpoint (1).

In any event, regardless of the debatable rationality (in terms of economic theory) of these criteria about the existence of an excessive deficit, the fact is they must be met if Spain is to be in a position to gain access to Monetary Union. Beyond the potentially harmful effects that the fiscal position may have on inflation or the external deficit (analysed elsewhere in this study), fiscal consolidation is an unavoidable obligation, imposed externally by the Maastricht Treaty.

Currently, the budget deficit/GDP ratio in Spain stands at 6.7 % in 1994, with public investment accounting, moreover, for only 3 % of GDP. As to the public debt/GDP ratio, this stood at 60.4 % in 1993, rising to 63 % in 1994. Further, the partial absolutions provided for in the Treaty cannot be applied, since these deviations cannot be classified as either exceptional or temporary.

Such non-compliance means that Spanish public finances fit the definition of an excessive budget deficit, meaning a process of budgetary consolidation is vital if Spain is to be part of Monetary Union. We are thus obliged to implement, as part of a convergence programme, fiscal policy measures to bring about the reduction of the budget deficit/GDP ratio and invert the current rising trend of public debt. The success of these measures, as the failure of the Spring 1992 Convergence Programme brings to mind, will depend on the following: awareness of the causes underpinning this excessive deficit; establishing means and measures to check the problem from the outset; and lastly, not having success hinge on uncontrollable exogenous variables, such as the pick-up in the national or international economy.

(1) In effect, the 60 % level would be attained in the long term if the deficit remained at 3 % of GDP, real GDP growth at 2.5 % (which would approximately be the long-term potential growth) and inflation at 2.7 %.

Before analysing the convergence programmes, it should be specified that the problem of the excessive Spanish deficit is far from an exception in the European context. Indeed, all European countries – excepting Germany, Ireland and Luxembourg – currently fail to meet the budget deficit criterion, albeit to differing degrees. In the Spanish case, the most worrying feature is, as earlier discussed, the trend growth of expenditure and systematic overrunning of forecasts.

IV.2. Convergence programmes

The Convergence Programme submitted by the government in spring 1992 sought, in addition to responding to the commitment undertaken with the European Commission, to frame an overall economic policy design. This design, in its strands of fiscal policy and structural reforms, would be such as to allow the Spanish economy to comply with the requirements governing access to the third stage of EMU in 1997.

A key element here was the fiscal policy stance in the following years. Indeed, although the stock of public debt stood at that time well below the requirement per the excessive deficit criteria, the budget deficit stood at 4.4 % of GDP in 1991 and was subsequently revised upwards to 4.9 %. That meant a fiscal consolidation drive had to be made. In effect, the programme aimed at a very ambitious and demanding budgetary consolidation target. Thus, for 1996, the overall general government deficit was set at 1 % of GDP. Naturally, it is now clear how unattainable this target was; such an ambitious fiscal consolidation plan was excessively wilful.

The failure to comply with the Convergence Programme, at least in its fiscal facet, was evident but a few months after its presentation. The ultimate reason for this was the excessive optimism of the programme's macroeconomic scenario: the forecast for GDP growth for 1992 and 1993 was 3 % and 3.3 %, respectively.

Actually, beneath the surface impression of severity in the budget deficit area, the fiscal consolidation project entailed but a scant effort to reduce the imbalance in public finances, as the reduction would be due exclusively to the high economic growth forecast. Set against the 3.4 percentage points decline in the budget deficit contained in the Programme (from 4.4 % of GDP to 1 % of GDP), the implicit reduction in the structural deficit was estimated at only 0.7 percentage points of GDP (2), the remainder corresponding to the effect of the cycle.

(2) The figures are taken from González-Páramo and Roldán (1992).

Exacerbating this excessive confidence in the recovery in activity as a deficit-attenuating factor was an insufficient assessment of the underlying structural tensions of the deficit. The budget deficit in 1991 (the year the Convergence Programme was set in motion) had thus been underestimated by half a point of GDP. Adding to this factor, which on its own might be viewed as almost anecdotal, were other problems, such as the build-up in the public health-care area of unrecognised spending for a total of PTA 461 billion.

In short, the first Convergence Programme failed with regard to the budgetary consolidation target. The cause was excessive confidence in the possibility of containing the tendency of the structural deficit to overrun and in the contribution of the business cycle to the decline in the budget deficit. Of these two elements, the latter undoubtedly played a greater role, since the forecast for real GDP growth was 3 % for 1992, 3.3 % for 1993 and 3.6 % for 1994 and 1995. However, had there been a commitment behind the budget deficit target to reduce the structural deficit, with this acting as an anchor for these budgetary consolidation objectives, the scale of the deviations by the Programme would have been less. Thus, the combination of excessive optimism about developments in activity and the lack of a target for reducing the structural deficit account for the premature failure of the Convergence Programme of Spring 1992.

The second Convergence Programme, approved in July 1994, incorporates the government's new commitment regarding fiscal consolidation and structural reform. Although neither the quantitative nor qualitative information is detailed enough to draw firm conclusions about the possibility of the planned policy succeeding, a preliminary reflection may be made.

The Programme's commitment in budget-deficit terms targets a drop from 7.3 % in 1993 (7.5 % after the latest revision) to 3 % in 1997, a reduction of 4.3 percentage points of GDP. In any event, the budget deficit in 1996 would exceed the ceiling set by the excessive deficit criterion by 1.4 percentage points, though it would be on a downtrend such as to meet one of the conditions of access to Monetary Union. Gross public debt, for its part, would increase by almost ten percentage points of GDP between 1993 and 1997, rising from 57.8 % of GDP (3) to 67.2 % of GDP, declining only in 1997 and by 0.3 percentage points of GDP. The 60 % limit would thus be exceeded, although 1997 would mark the start of a declining path that might also suffice to meet another of the conditions pacted under the European Union Treaty for Monetary Union membership.

(3) The gross public debt/GDP ratio for 1993 is currently estimated at 60.4 %.

Regarding the distribution by government level (see Table IV.1) of this commitment to reduce the budget deficit, the biggest drive in absolute terms is to be made by central government. Thus, while the territorial governments would lower their deficit by 0.9 percentage points of GDP – from 1.2 % in 1993 (1.3 % after the latest revision) to 0.3 % in 1997 – , central government would cut their deficit by 3.4 percentage points of GDP. Although the quantitative impact of the measures envisaged in the Programme is not detailed, the reduction target would be supported by three pillars: the cut in public spending by three percentage points; the maintenance of the individual tax burden (foreseeing, in effect, a fall in the revenue/GDP ratio); and a series of structural reforms to smooth attainment of the deficit-cutting goal, improving the efficiency and competitiveness of the Spanish economy. While these structural measures are not sufficiently specified either, the most important ones would be the reform of the Budget Law; the improvement of management procedures; the reform of benefits for sick leave from work (unifying temporary labour disability and provisional invalidity, and reducing their excessive duration, of up to six years), as already expressed in the budget for 1995; combating tax fraud, etc.

The spending component where the biggest containment effort is to be made is government consumption. Specifically, it is sought in the general government area to reduce the weight of this item in terms of GDP from the level of 17.2 % in 1993 (17.5 % following the latest revision) to 15.7 % in 1997, a decline of 1.5 percentage points of GDP. In this connection, measures such as the following would be established: wage settlements in terms of forecast inflation; the containment of public-sector employment (only 50 % of vacancies arising would be covered, with exceptions made for certain under-staffed bodies, this directive having been substantially amended further to agreements with the trade unions); and the charging of levies for the provision of certain public services. Some ambiguity remains in the area of public investment, where no quantification has been offered, it being stated that an infrastructure investment drive greater than that of the EU average will be sustained. Lastly, regarding transfers, the reform of disability benefits has been announced, as has the reinforcement of the contributory nature of pensions and the maintenance of their purchasing power.

Turning to revenue, the maintenance of the individual tax burden is ensured, and a fall in the revenue/GDP ratio is tentatively forecast. This fall would be the outcome of (i) the smaller profits of the Banco de España (which were extraordinarily high in 1992 and 1993, making for a considerable increase in State revenue from profits and dividends in 1993 and 1994); (ii) the delayed impact of the recession on revenue; and (iii) the discretionary investment-promoting measures in the area of corporate income tax. Likewise, the emphasis on the privatisation of State-owned

TABLE IV.1

THE JULY 1994 CONVERGENCE PROGRAMME (a)

	1993	1994	1995	1996	1997
PERCENTAGE OF GDP:					
General government deficit	7.3	6.7	5.9	4.4	3.0
Central government	6.1	5.7	5.1	3.8	2.7
State	5.8	5.0	4.6	3.5	2.5
Social Security and central government administrative agencies	0.3	0.7	0.5	0.3	0.2
Territorial governments	1.2	1.0	0.8	0.6	0.3
Debt					
Gross	57.8	62.7	65.9	67.5	67.2
Net	55.8	60.7	63.9	65.5	65.2
GDP GROWTHS (%):					
MEMORANDUM ITEM:					
Nominal	3.6	5.8	6.5	7.5	8.6
Real	-1.0	1.3	2.8	3.9	3.9
Deflator	4.6	4.4	3.6	4.0	4.0

Source: *Programa de Convergencia*, Ministerio de Economía y Hacienda.

(a) The figures for 1996 and 1997 for real growth and the deflator are averages. All figures in Spanish National Accounts terms.

companies is apparently to be lessened, it being argued that the size of the Spanish public corporate sector is less than that in most EU countries (4).

Table IV.2 (5) details, for central government, the foreseeable course of expenditure, revenue and the deficit (in budgetary accounting terms, which explains the discrepancy in the deficit figures between Tables IV.1 and IV.2). As can be seen, the cut in the budget deficit is attained thanks to the reduction in the expenditure/GDP ratio of almost four percentage points. In fact, the revenue/GDP ratio diminishes by half a point. As to the intensity of the spending-containment drive, this is focused on 1995, in which the spending/GDP ratio falls by 1.5 percentage points (with nominal growth running at a most moderate rate of 2.6 %). However, the loss of revenue that the Programme foresees for 1995 prevents this restrictive drive from taking the form of a bigger reduction in the deficit during the

(4) That said, the 1995 Budget includes revenue from privatisation proceeds amounting to about PTA 300 billion, some privatisations having already been carried out while others are under way.

(5) The absence of figures for 1993, along with the lack of a consolidated outturn for central government as a whole, accounts for the gaps in the information furnished.

TABLE IV.2

CENTRAL GOVERNMENT: REVENUE AND EXPENDITURE (a)

	1993	1994	1995	1996	1997
PERCENTAGE OF GDP:					
Expenditure		40.3	38.8	37.8	36.9
Revenue		34.8	33.8	34.1	34.3
Deficit		5.5	5.0	3.7	2.6
ABSOLUTE CHANGES (IN PERCENTAGE POINTS OF GDP):					
Expenditure			-1.5	-1.0	-0.9
Revenue			-1.0	0.3	0.2
Deficit			-0.5	-1.3	-1.1
GROWTH RATES (%):					
Expenditure			2.6	4.8	5.9
Revenue			3.5	8.5	9.1
Deficit			-3.2	-20.3	-23.5
GDP GROWTH (%):					
MEMORANDUM ITEM:					
Nominal	3.6	5.8	6.5	7.5	8.6

Source: *Programa de Convergencia*, Ministerio de Economía y Hacienda.

(a) In budgetary terms.

year. In any event, these two characteristics – the adjustment via spending and the front-loaded nature of the containment drive – clearly differentiate the present Convergence Programme from its predecessor, in which the budgetary consolidation goal was pursued via an appreciable increase in revenue, and in the latter years of its duration.

In sum, despite the gaps in the Programme (namely, the absence of detailed information and the lack of specificity of the structural reforms affecting the course of revenue and spending), it does establish a clear, discernible commitment to reduce the budget deficit thanks to a cut in public spending in the early years of the period in question. Rigorous compliance with this commitment in 1995 and 1996 is essential in view of the Programme's optimism about foreseeable nominal GDP growth in the later years and owing to how tight attainment of the budgetary consolidation goal will be.

IV.3. Public debt

Changes in public debt expressed as a proportion of GDP are proving of great importance for the analysis of public sector activity. This is so for

several reasons. First, because it is one of the factors to be taken into account, under the Maastricht Treaty, on determining whether there is an excessive budget deficit problem (although the Treaty is ambiguously worded when specifying this criterion). Further, it allows general government conduct to be analysed taking the approach of the financial view of revenue and expenditure transactions, which acts as a consistency test for what is obtained from the angle of non-financial operations. This is most relevant bearing in mind that changes in gross public debt are not prone to the problems of creative accounting (mainly via fictitious financial assets) which frequently distort the meaning of the budget balance. Moreover, it can act as a leading indicator of fiscal policy, especially in the case of territorial tax administration, whose agents provide but greatly lagged and incomplete information of their non-financial transactions.

But besides these more or less indirect reasons, the debt/GDP ratio is of interest in itself due to its macroeconomic impact. Questions such as the effect of fiscal policy on real long-term interest rates or the long-term sustainability of fiscal policy hinge directly on developments in the debt/GDP ratio.

This section briefly reviews the debt/GDP ratio and its determinants, comparing it, in turn, with developments in other European countries and projecting its future path in terms of alternative circumstances that aim to reflect the sensitivity of the ratio to changes in its determinants. Questions such as the impact of the debt/GDP ratio on interest rates, or the sustainability of debt and the measurement thereof, are thus set aside, requiring as they would a more detailed analysis (6).

IV.3.1. *The dynamics of debt*

Public debt moves over time in keeping with the following relationship:

$$D_{t+1} = D_t (1 + i) - S_t \quad [I]$$

where D_t is public debt at the beginning of year t (or at the end of year $t-1$), S_t is the primary surplus and i is the nominal interest rate (in $t-1$). As percentages of GDP, this relationship would be:

$$d_{t+1} = d_t \frac{(1 + i)}{(1 + n_t)} - s_t \quad [II]$$

(6) A more detailed analysis of these issues can be found in González-Páramo, Roldán and Sebastián (1991) and Ballabriga, Dolado and Viñals (1991).

where n is the nominal growth of the economy in year t . Note that only if the nominal interest rate were greater than nominal growth could there be a problem of sustainability (otherwise public debt, as a proportion of GDP, would tend towards zero in the long term). Nonetheless, even if the nominal interest rate were not to exceed nominal growth, increases in the debt/GDP ratio would foreseeably affect the interest rate ultimately, raising it and eventually generating problems of sustainability.

Before analysing changes in this debt ratio in Spain and in other EU countries, it should be specified that the above expression is applied for net debt (financial liabilities less financial assets), while it is gross debt that is the concern of this study. In principle, for questions of sustainability, of potential impact on the course of interest rates, the net position – public debt minus financial assets – should be analysed. However, the possibility of the aforementioned creative accounting techniques being used to mask part of the budget deficit means that the net position is, to say the least, equivocal. It is, therefore, more advisable to consider gross debt. Further, and not for reasons other than those indicated, the Maastricht Treaty refers always to gross public debt when setting the excessive budget deficit criteria.

But despite the soundness of these reasons (which prove determinative), taking only the gross position into account and leaving asset analysis aside may distort the analysis. Thus, for example, in the case of Denmark, the existence of deposits in the central bank for the management of foreign reserves coupled with the assets held by the Danish Pension Social Fund biases the debt ratio upwards by approximately twenty percentage points of GDP.

IV.3.2. Comparison of movements in public debt: 1982-1994

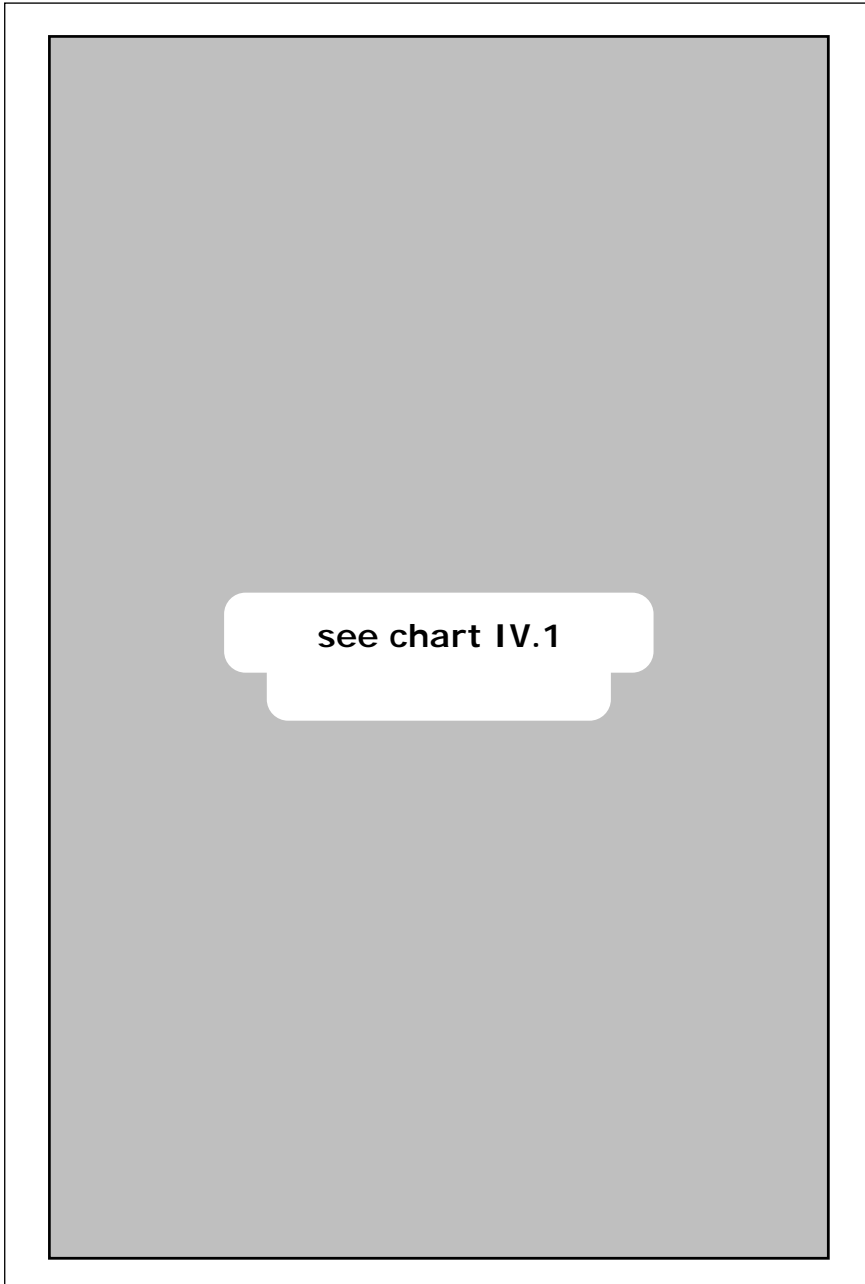
Charts IV.1 to IV.7 depict public debt and its determinants for Spain and six other EU countries – Germany, France, Italy, United Kingdom, the Netherlands and Belgium – in the period 1982-1994. Taking the top chart first, this shows us developments in gross debt from 1982 onwards, the ceiling on debt set at Maastricht (60 % of GDP) and the public debt that would result from the accumulation of past budget deficits (taking the stock of debt in 1980 as a base). Regarding this latter concept, the aim is simply to illustrate the course of financial assets (which, in principle, should coincide with the difference between gross debt and that resulting from the accumulation of the deficits, according to expression [II]). Insofar as these financial assets are mostly fictitious, the differing trends of gross debt and net debt (understood as that resulting from the accumulation of budget deficits) offer information about the role of fictitious assets on smoothing the trend of the deficit over time.

The central chart depicts the effect on movements in the debt/GDP ratio of the primary balance and the differential between GDP growth and the effective interest rate on gross debt. This effective interest rate is defined as the ratio of the interest burden in a specific year to public debt in circulation at the beginning of the same year (or at the end of the previous year). The bottom chart confines itself to separating this differential into two components: the growth rate and the effective interest rate. This effective interest rate does not generally coincide with the rate at issue of public debt (since the rate on the debt will depend on the rates ruling as of the time of issue of each of the securities making up the debt). And nor will it generally be the average rate on debt issued under regular market conditions (insofar as there are public debt securities, such as special government debt, the cost of which is lower than that prevailing in the market at the time of issue). Lastly, it should be remembered that, for there to be problems of sustainability of public debt, a necessary condition is that this differential (the GDP growth rate less the effective interest rate on public debt) should be negative. If it is negative, the government, aiming at meeting solvency conditions, will be obliged at some point to generate primary surpluses.

Chart IV.1 shows Spanish public debt and its determinants. As the top chart evidences, gross public debt has grown intensely in Spain, moving from 26.5 % of GDP in 1982 to an estimated 63 % for 1994, exceeding the 60 % ceiling since 1993. If the course of accumulated deficits is observed, we also see there is a high growth in financial assets, particularly during periods of high deficits (between 1984 and 1986). That points to the use of fictitious financial assets to lessen the impact of the crisis (or of fiscal policy loosening) on the budget deficit figures, shifting part of this effect to the future.

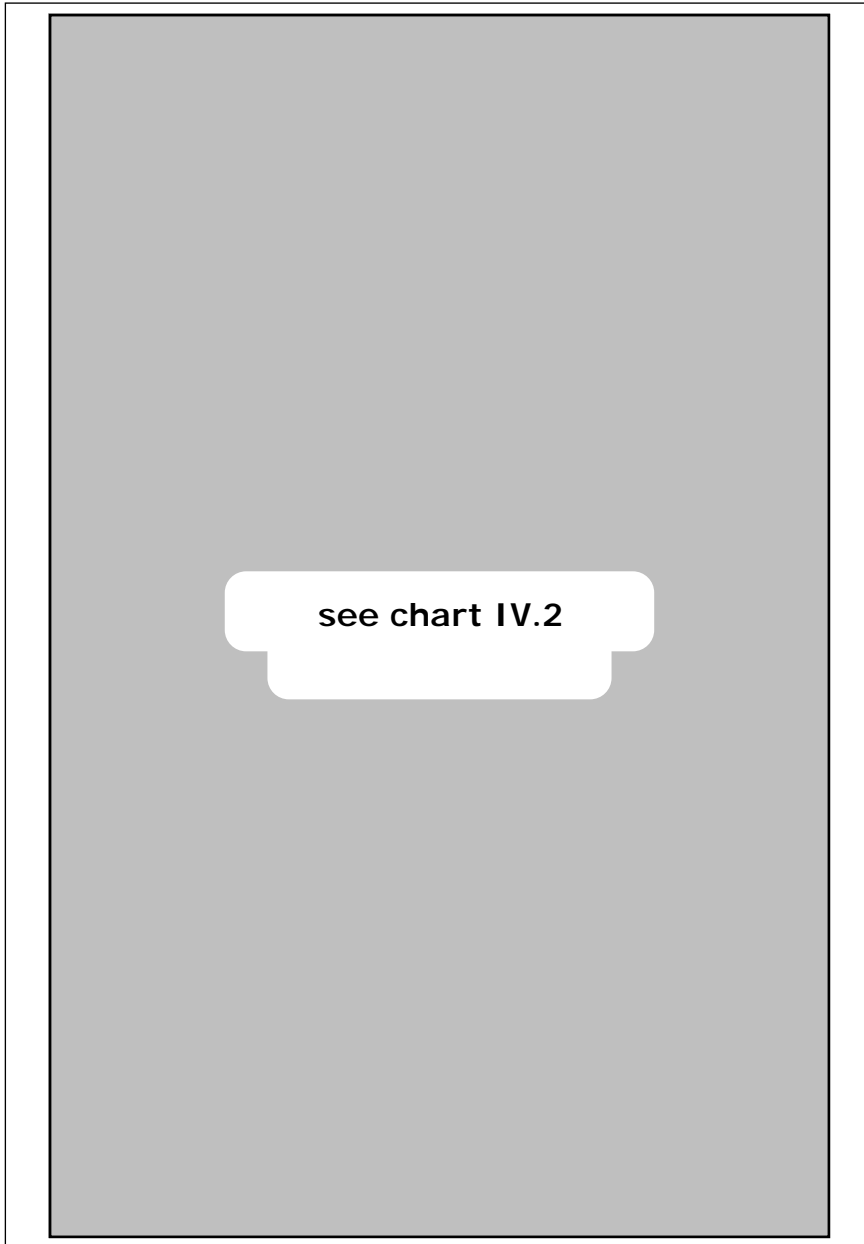
Moving to the underlying factors of these dynamics, the first prominent fact is that the differential between real GDP growth and the real interest rate is positive for most of the period considered. Indeed, until 1991 there was no public debt sustainability problem. However, after 1991 this differential turned very negative (approaching eight percentage points in 1993 and still over three percentage points in 1994), which accounts for the surge in the growth of debt between 1991 and 1994. As regards the course of the primary balance, three different periods can be distinguished: (i) from 1982 to 1987, marked by a primary deficit of a sizable magnitude, but diminishing to reach primary equilibrium in 1987; (ii) from 1987 to 1992, marked by fluctuations of the primary balance around zero; and (iii) the years 1993 and 1994, in the first of which there was a considerable deterioration of the primary balance (though far off the high levels reached in the early eighties), corrected to a very minor extent during 1994. In 1993, the combination of the rise in the primary deficit with the

SPAIN



Sources: Ministerio de Economía y Hacienda and Banco de España.
 (a) Real GDP growth rate less real effective interest rate on gross debt.

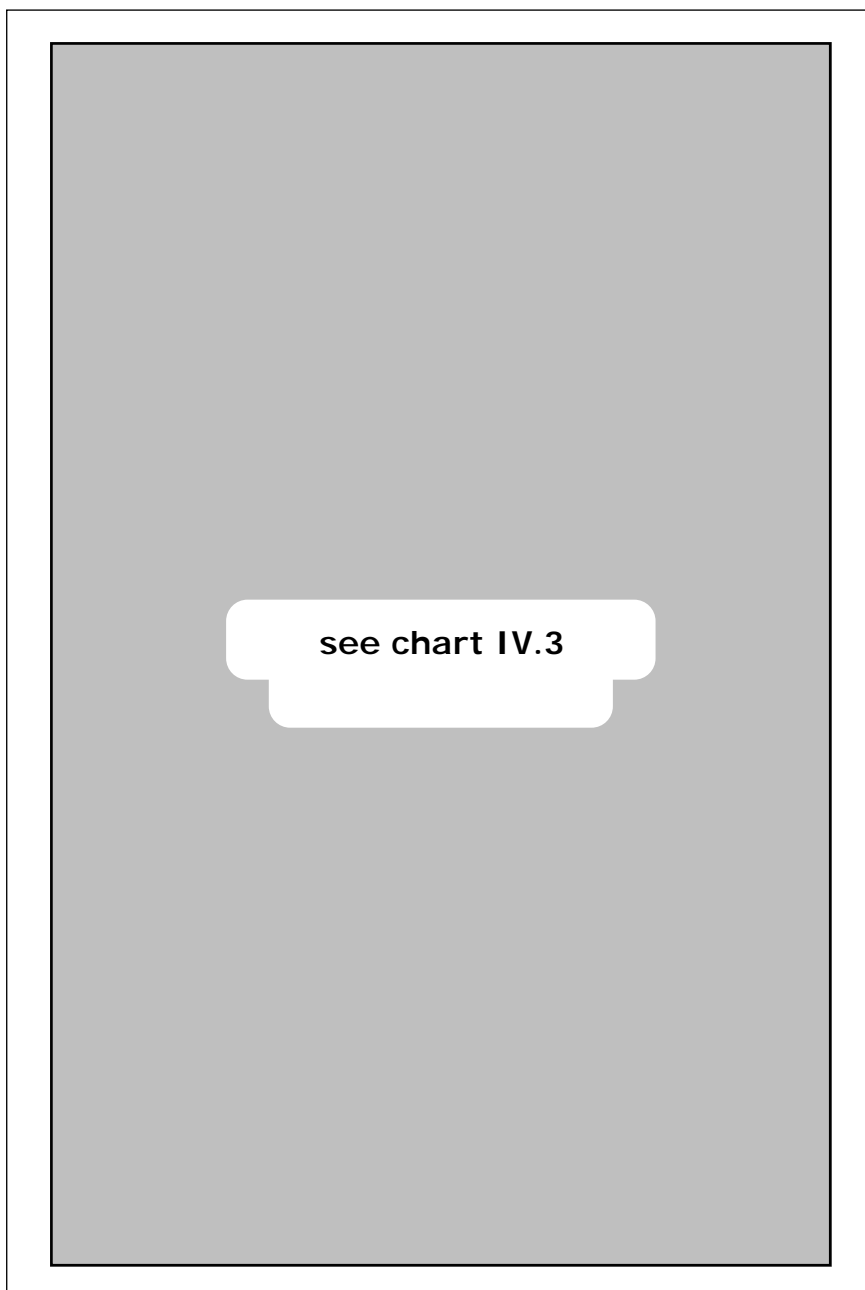
GERMANY (a)



Sources: European Commission and IMF.

- (a) To 1990, western Germany.
- (b) Spliced series.
- (c) Real GDP growth rate less real interest rate on gross debt.

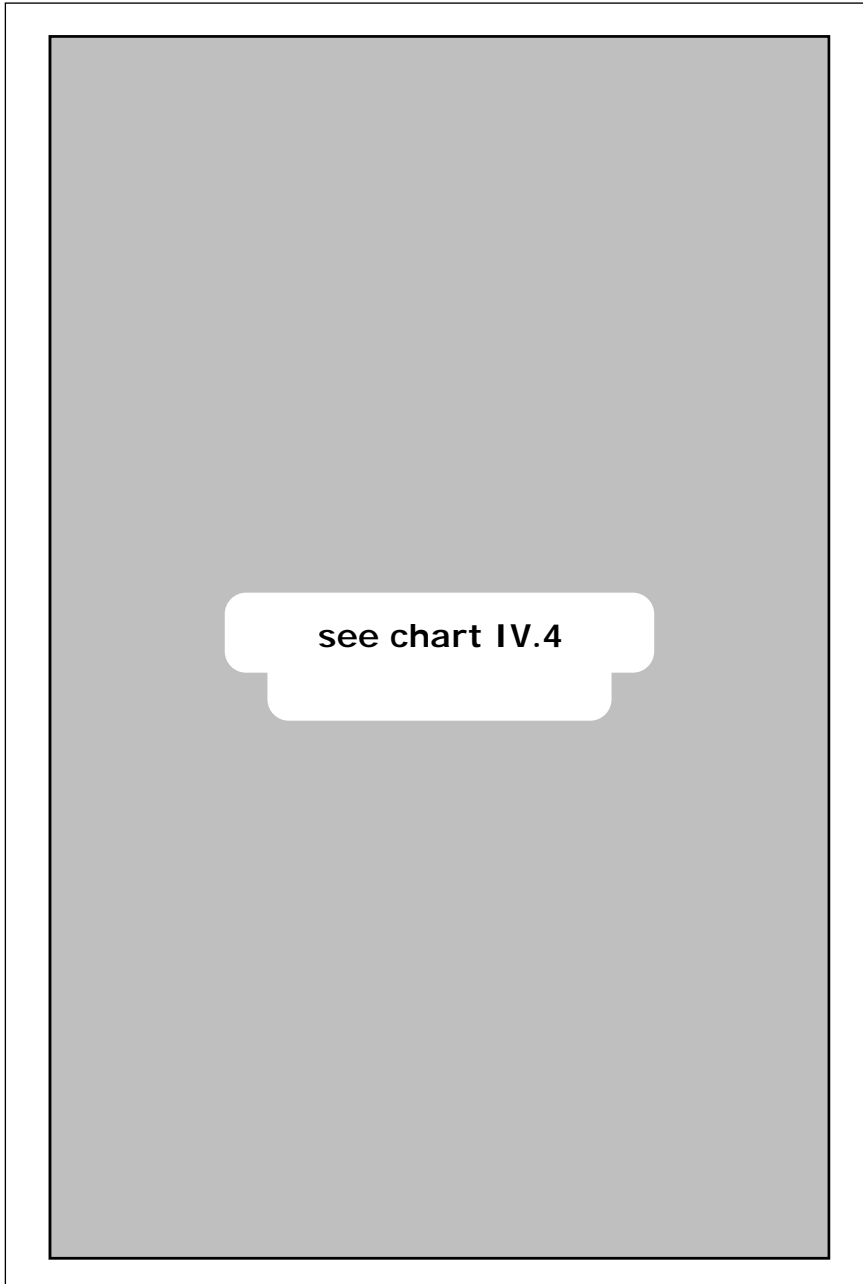
FRANCE



Source: European Commission.

(a) Real GDP growth rate less real effective interest rate on gross debt.

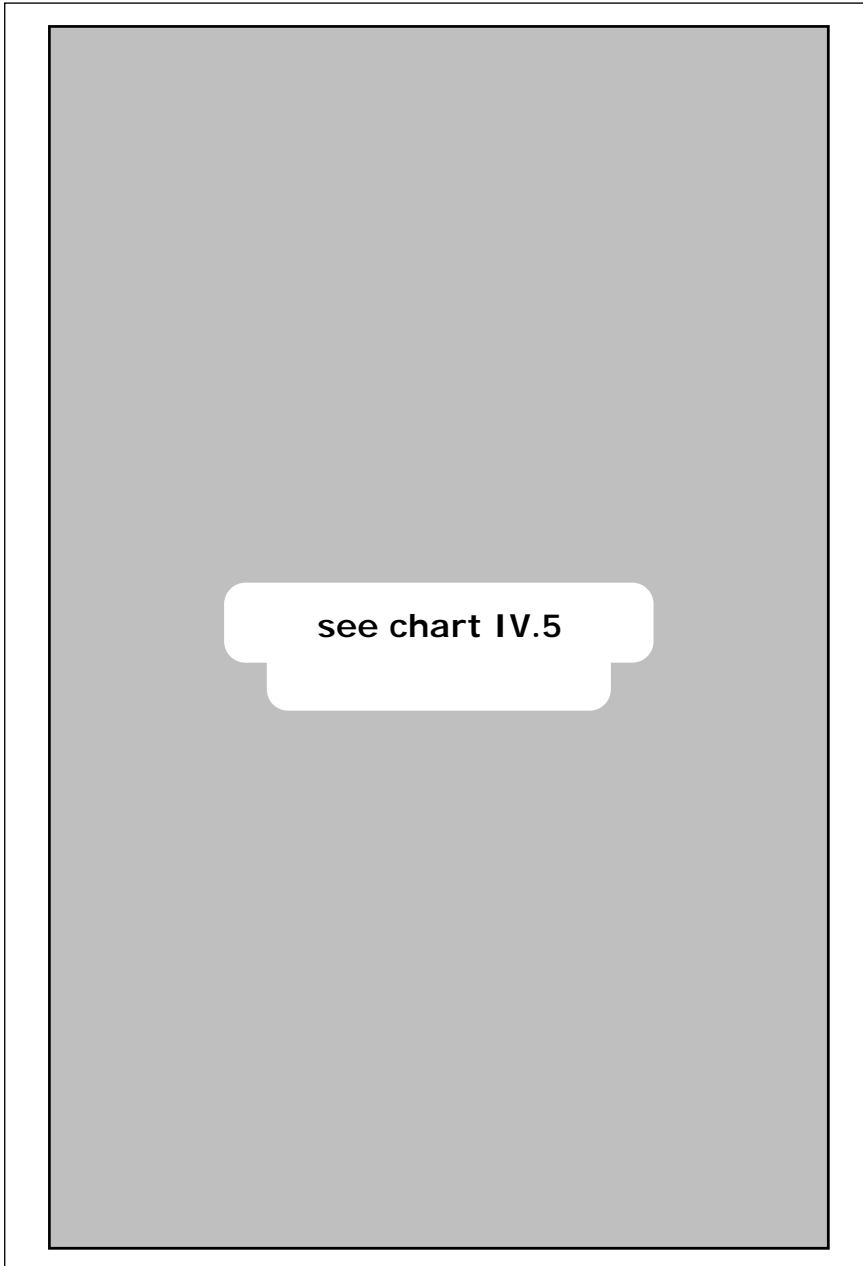
ITALY



Source: European Commission.

(a) Real GDP growth rate less real effective interest rate on gross debt.

UNITED KINGDOM

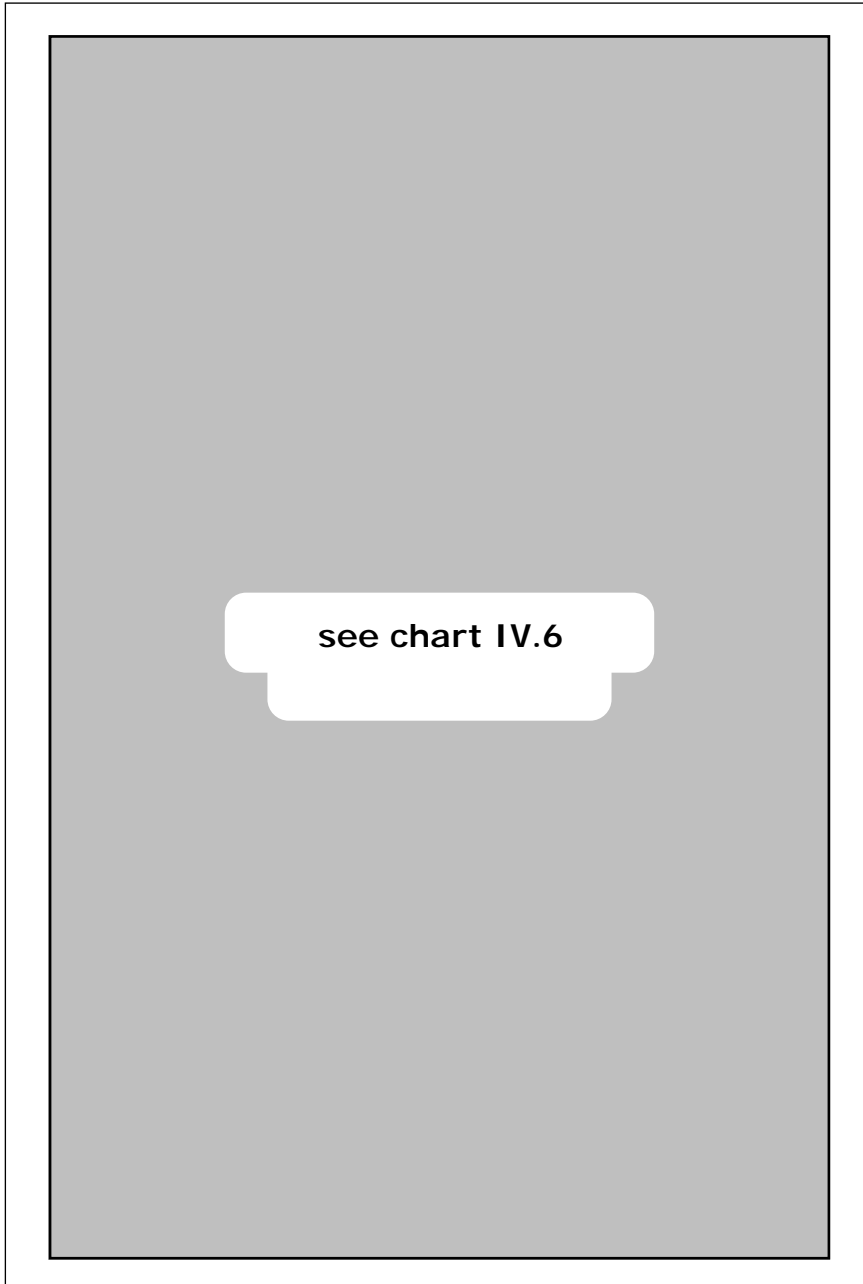


Source: European Commission.

(a) Spliced series.

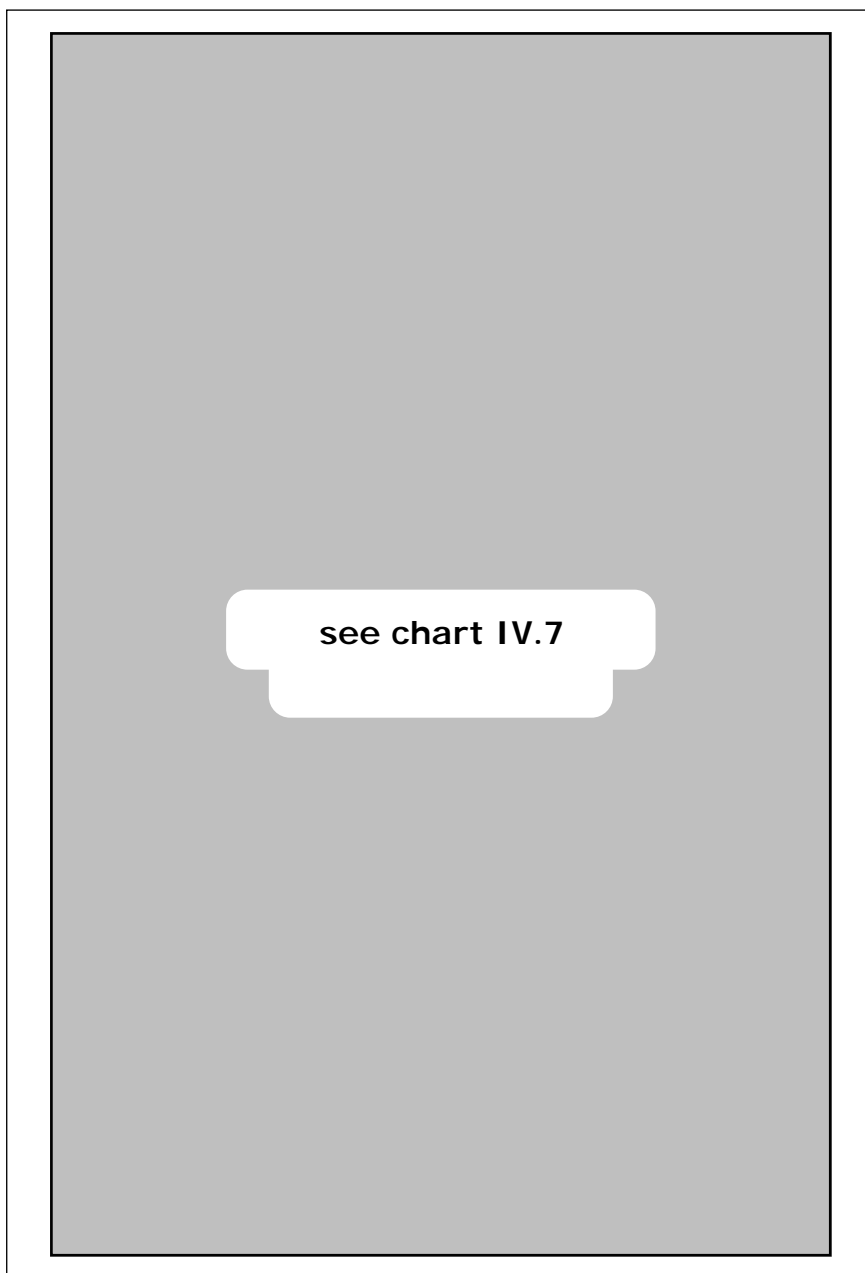
(b) Real GDP growth rate less real effective interest rate on gross debt.

NETHERLANDS



Source: European Commission.

(a) Real GDP growth rate less real effective interest rate on gross debt.

BELGIUM

Source: European Commission.

(a) Spliced series.

(b) Real GDP growth rate less real effective interest rate on gross debt.

increase in the differential between GDP growth and the effective cost of public debt account – along with the increase in financial assets (7) – for the growth of the debt/GDP ratio by twelve percentage points.

Lastly, the decomposition of the differential into real GDP growth and into the real effective interest rate on the debt is shown in the bottom chart. The highlight of real GDP growth is its strength, although from 1987 onwards a slow deceleration of this growth is discernible, culminating in the 1993 recession and the start of a new period of growth in 1994. As to the real effective interest rate, it can be seen to be on a rising trend throughout the period, this being particularly intense in the sub-periods 1982-87 and 1990-94. The trend reflects the increase in financing at market prices, associated with the disappearance of the monetisation of the deficit (at the outset of the eighties), financing via compulsory investment reserves, and the use of public debt securities that were opaque for tax purposes. In any event, this process of adaptation to debt financing under market conditions is almost complete (now Treasury recourse to the Banco de España has been eliminated, only special government debt remains). Accordingly, this effective cost of debt will not grow notably in the coming years.

Turning to the international comparison, Charts IV.2 to IV.7 address public debt and its determinants in Germany, France, Italy, United Kingdom, the Netherlands and Belgium, respectively. Despite differing trends in these countries, some economic policy conclusions can be drawn.

First, changes in the differential between the real GDP growth and the effective interest rate in these countries are far different than in Spain. In none of these countries has this differential been persistently positive, meaning that Spain has enjoyed what might be termed a privileged situation which has, in any event, now run its course. This relatively favourable situation was attributable more to the lower effective cost of debt than it was to the Spanish economy's high growth rate. Among the countries considered, two sub-groups can be distinguished. In one group, comprising Germany, United Kingdom, the Netherlands and Belgium, the effective cost of debt, though fluctuating, is not on a rising trend (thereby indicating the absence of privileged financing). The second group, made up of France, Italy and Spain, shows growth of the effective interest on debt throughout the period considered. That points to the existence of means of privileged financing, which have progressively been disappearing during the eighties. In any event, of these three countries it is Spain which

(7) In 1993, and as a result of the disappearance of Treasury recourse to (i.e. borrowing from) the Banco de España, there was an over-issue of long-term public debt aimed at creating a liquidity buffer in the Treasury's account at the Banco de España. This accounts for part of the heavy increase in the debt/GDP ratio that year.

departed in the early eighties from a lower effective cost, whereby it enjoyed a better initial situation than the other two countries.

Regarding the primary balance, the main conclusion drawn from the international comparison is that in those countries where the debt/GDP ratio has reached very high levels, there is a primary surplus. This is the case of Italy, the Netherlands and, in particular, Belgium. The build-up of public debt conclusively leads to a decline in fiscal policy leeway, thus forcing through a considerable slide in public spending, excluding interest. In short, high budget deficits make a contraction of the primary deficit necessary sooner or later; accordingly, from the standpoint of the supply of public goods, such supply cannot be financed indefinitely with public debt.

Lastly, it should be highlighted how the experience of countries with higher debt/GDP ratios (that of Italy in particular) is illustrative of the dangers that arise by allowing high deficits over prolonged periods. Italy, indeed, set out in 1982 with a situation giving little rise to concern: it had a debt/GDP ratio of 65 % and a very low effective interest rate on its debt (lower than – 3 % in real terms). Despite this, the persistence of a primary deficit of over 3 % until about 1988 led debt to settle at over 90 % of GDP. In just six years, Italy's excessively expansionary fiscal policy brought debt onto an explosive path.

In sum, several conclusions can be drawn from the comparison of the patterns of public debt and its determinants. First, that Spain enjoyed a relatively advantageous situation, since access to means of privileged financing meant that the effective cost of its debt could be very low compared with that of other countries. Second, that this advantage has now disappeared as the public sector no longer has access to privileged financing. Third, that the persistence of high deficits leads unavoidably to cuts in the supply of public goods (to increases in the primary surplus); accordingly, the question is not whether to pursue a contractionary fiscal policy, but when to do so, with low debt ratios (which increases the margin for manoeuvre of fiscal policy) or high ones (which completely eliminates such margin for manoeuvre). Lastly, the experience of countries with high debt/GDP ratios (specifically Italy) indicates that only a few short years of fiscal uncontrol are needed to place debt on an explosive path.

IV.3.3. Public debt to the year 2000

Table IV.3 and Chart IV.8 trace the course of the budget deficit and public debt in alternative frameworks of developments in prices (encom-

TABLE IV.3

**DEFICIT AND DEBT DEVELOPMENTS
(1994-1999)**

%

	<i>Assumptions</i>				<i>Results</i>	
	<i>Primary surplus (% of GDP)</i>	<i>Nominal interest</i>	<i>GDP deflator</i>	<i>Real GDP</i>	<i>Debt/GDP ratio</i>	<i>Budget deficit (% of GDP)</i>
BASE SCENARIO:						
1994	-1.4	9.3	4.1	2.0	63.0	6.7
1995	-0.7	8.8	3.6	2.8	65.1	5.9
1996	0.8	8.5	3.3	3.5	65.2	4.4
1997	2.0	8.2	3.0	3.5	64.2	3.0
1998	3.0	8.2	3.0	3.5	62.1	1.9
1999	3.8	8.2	3.0	3.5	59.2	1.0
NO ADJUSTMENT (a):						
1994	-1.4	9.3	4.1	2.0	63.0	6.7
1995	-1.4	8.8	3.6	2.8	65.7	6.6
1996	-1.4	8.5	3.3	3.5	68.1	6.6
1997	-1.4	8.2	3.0	3.5	70.4	6.6
1998	-1.4	8.2	3.0	3.5	72.8	6.8
1999	-1.4	8.2	3.0	3.5	75.3	7.0
LOWER-THAN-EXPECTED GROWTH (b):						
1994	-1.4	9.3	4.1	2.0	63.0	6.7
1995	-0.7	8.8	3.6	2.5	65.2	5.9
1996	0.8	8.5	3.3	2.5	66.0	4.4
1997	2.0	8.2	3.0	2.5	65.7	3.1
1998	3.0	8.2	3.0	2.5	64.3	2.1
1999	3.8	8.2	3.0	2.5	62.1	1.2
PRICE STABILISATION (c):						
1994	-1.4	9.3	4.1	2.0	63.0	6.7
1995	-0.7	9.3	4.1	2.8	65.0	6.2
1996	0.8	9.3	4.1	3.5	65.2	4.8
1997	2.0	9.3	4.1	3.5	64.1	3.6
1998	3.0	9.3	4.1	3.5	62.0	2.5
1999	3.8	9.3	4.1	3.5	59.1	1.5
PESSIMISTIC SCENARIO (d):						
1994	-1.4	9.3	4.1	2.0	63.0	6.7
1995	-1.4	9.3	4.1	2.5	65.9	6.9
1996	-1.4	9.3	4.1	2.5	68.9	7.1
1997	-1.4	9.3	4.1	2.5	71.9	7.4
1998	-1.4	9.3	4.1	2.5	75.0	7.6
1999	-1.4	9.3	4.1	2.5	78.2	7.9

Sources: Ministerio de Economía y Hacienda, Banco de España and own calculation.

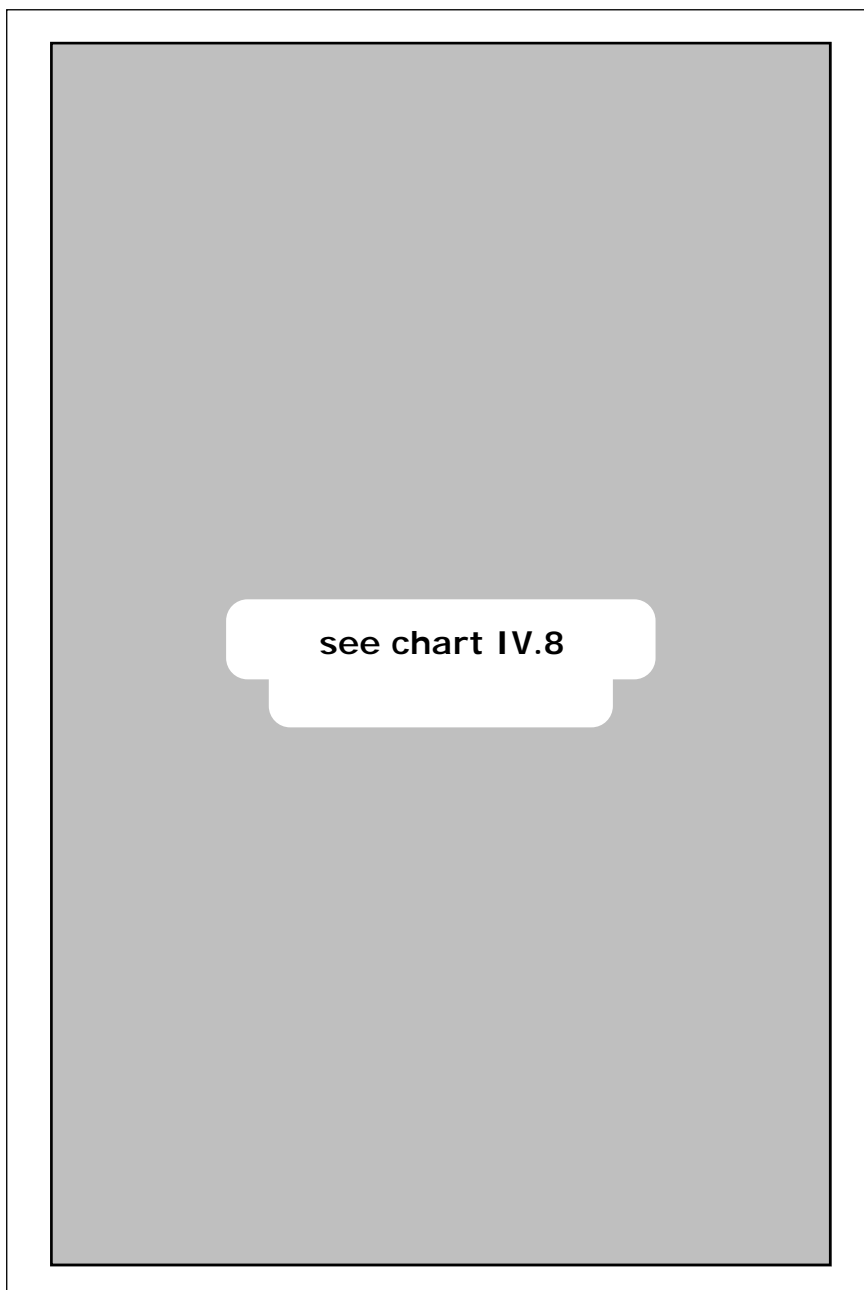
(a) If the primary deficit does not vary.

(b) If GDP growth does not exceed 2.5 % from 1995 onwards.

(c) If the GDP deflator does not drop below 4.4 %.

(d) Combination of the three foregoing scenarios.

**DEFICIT AND DEBT DEVELOPMENTS
(1991-1999)**



Sources: Ministerio de Economía y Hacienda, Banco de España and own calculation.

passed in the GDP deflator), real growth, and fiscal policy stance (encompassed in the forecast for the primary surplus). It is assumed that the nominal interest rate (calculated for the first year as the 1994 interest burden divided by the stock of public debt in circulation at the end of 1993) trends in line with prices, so that falls in inflation (in the GDP deflator) lead to falls of the same magnitude in the interest rate. Accordingly, the hypothesis of constant real interest rates is maintained.

The basic framework seeks to outline a macroeconomic and fiscal situation that would enable Spain to be in a position to join the Economic and Monetary Union in 1999. Unlike the Convergence Programme, a more intense slowdown in prices is assumed (a bigger fall in the GDP deflator), although so too is appreciably lower real GDP growth (it would not exceed 3.5 %). The results are, in any case, quantitatively similar: the deficit stands at 3 % in 1997 – and at 1 % in 1999 – and debt begins to fall as from 1996 to below 60 % by the end of the century. The main difference with the Convergence Programme is that public debt, in this simulation, would be three percentage points lower than the related Convergence Programme forecast. The source of this difference may lie either in the nominal interest rate considered (which is greater in the Convergence Programme) or in the existence of assumed debt of public-sector corporations, reflected in public debt and not in the deficit.

The alternative scenarios considered -non-existence of a contractionary fiscal policy, lower-than-expected growth, stabilisation of prices and another, of a pessimistic hue, combining all the aforementioned ones- seek to track the sensitivity of the course of the deficit and of debt to changes in their determinants. As regards the lower-growth scenario, it should be underscored that it does not take into account the impact of the cycle on the budget deficit; as a result, holding on the path of primary-surplus reduction would require a greater fiscal containment drive.

With regard to the results in Chart IV.8, the main conclusions are as follows:

- The absence of a fiscal consolidation drive and the downward stickiness of inflation would prevent the budget deficit target being met in 1997.
- As to public debt, the inertia of its growth makes it impossible to prevent its growth in the initial years, meaning it will be above the 60 % threshold in 1997. Unlike the case with the budget deficit, public debt is not very influenced by greater inflation. It is, however, affected by lower-than-forecast real growth in the basic scenario. In the absence of any correction of the primary deficit, this would entail placing public debt on a path of permanent growth which, logically, would prove unsustainable in the medium term.

- The so-called pessimistic scenario (which is not in fact far removed from the basic scenario, except in the lack of fiscal-policy containment) illustrates the dangers of an absence of fiscal consolidation that ultimately affects real growth and inflation expectations. In such a case, in the run-up to the year 2000, public debt and the budget deficit would be on a path that would lead Spain, in a few short years, to a situation similar to that of countries such as Belgium or Italy.

In short, the simulations performed confirm that although the fiscal consolidation drive needed to contain the growth of debt is great, greater still are the dangers of abandoning control of the budget shortfall. To summarise, it seems vital that, in the coming years, the moderately contractionary stance adopted by fiscal policy in 1994 should be intensified: first, to permit access to the Monetary Union; and further, to prevent Spanish public finances reaching a point of deterioration requiring a most costly correction.

V

SUMMARY AND CONCLUSIONS

From 1988 to 1993, the budget deficit widened considerably to 7.5 % of GDP in the latter year. True, the economic recession can account for part of the increase in the deficit. But most of this deterioration is due to a discretionary rise in public spending (underpinned by the extension of welfare-state entitlement spending), which rises in revenue were unable to offset. Moreover, while the increase in public spending has been of a permanent nature, the rise in revenue has largely been temporary. That will require a greater degree of rigour in the control of public spending in the coming years so as to avoid an additional widening of the deficit.

This drive to cut spending in 1994 was moderate, although it meant a turnaround on the pattern of previous years. Deprived of a portion of the aforementioned revenue of a temporary nature, it only provided for a reduction of the budget deficit to 6.7 % of GDP. This came about, moreover, in a year of economic recovery, with higher-than-forecast growth. The aim set out in the Convergence Programme to lower the deficit to 5.9 % of GDP in 1995 implies a lesser containment drive than that made in 1994 in view of the expected improvement in economic circumstances. Accordingly, this figure needs to be strictly observed, thereby enabling the move onto the fiscal consolidation path foreseen for the coming years.

The fiscal policy stance over the period under study was expansionary and, in the cyclical upswing, tended to exacerbate the economy's disequilibria. Disaggregated analysis of revenue and expenditure confirms the expansionary effect of the latter since 1988, an effect not offset by the revenue side.

Fiscal policy must have had a quite appreciable inflationary impact. Thus, the growth of public spending and final general government demand has, in the past twenty years, been systematically higher than that of national demand. Adding to this medium-term influence from 1988 onwards was the change in fiscal policy settings, which may have contribut-

ed to exacerbate the inflationary pressures triggered by the cyclical upturn in the economy.

As regards the scant correlation observed between the budget deficit and the current-account deficit (particularly in 1993), this should not lead to an underestimation of the potential impact of fiscal policy on the current-account deficit. Indeed, the recession may have masked the effect that the widening of the budget imbalance may have had on the balance-of-payments deficit on current account. The economic recovery and the pick-up in private consumption and in productive and residential investment, together with the diminished financing capacity of the private sector that this entails, may bring to light these potential effects of fiscal policy on the current-account deficit.

The evidence gathered on budgetary deviations confirms there is a problem in the fiscal policy area, which arises due to the scant effectiveness of budgetary restraint. Shortcomings in institutional arrangements, both in budgetary control techniques and in the way the Budget is approved, may account for such inefficiency.

Like many other EU countries, Spain currently fails to meet the excessive-deficit criterion required to join Monetary Union. This led in 1994 to a new Convergence Plan being submitted, to provide for compliance with this condition. The first Convergence Programme did not attain the budgetary consolidation foreseen, owing to excessive wilfulness regarding both the possibility of curbing the tendency of the structural deficit to overrun and the quantification of the cyclical component of the budget deficit. As to the new Convergence Programme, it establishes -despite several gaps- a clear, accurate commitment to reduce the budget deficit thanks to a cut in public spending in the initial years of the period it spans. In spite of this commitment, the Programme's optimism (regarding attainable growth), the tight budgetary consolidation target set and the absence of an explanation detailing the means that will enable these objectives to be achieved mean that exceptional rigour will be vital in its implementation.

With respect to public debt, the following conclusions were reached further to the comparative analysis of its dynamics. First, that Spain benefited in the past from an advantageous situation since access to privileged means of financing meant that the effective cost of debt was relatively low compared with that of other European countries. Second, that this advantage has now disappeared because the public sector no longer has access to privileged means of financing. Third, that the persistence of heavy deficits has forced those countries with high debt/GDP ratios into cuts in their supply of public goods (into increases in their primary surplus); accordingly, the question is not whether to pursue a contractionary

fiscal policy, but when to do so, with low debt ratios (which increases the margin for manoeuvre of fiscal policy) or high ones (which completely eliminates such margin for manoeuvre). Lastly, the experience of countries with high debt/GDP ratios indicates that only a few short years of high deficits are needed to place debt on an explosive path. Indeed, the simulations performed confirm that the dangers and costs of relinquishing control of the budget deficit are enormous.

It is, in conclusion, of paramount importance that the change in fiscal policy stance embarked upon in 1994 be consolidated in the coming years. The tightening of the stance should be intensified so as to be in a position to join Monetary Union and avoid a deterioration of Spanish public finances that would prove most difficult to correct.

APPENDIX 1

FISCAL POLICY MEASURES IN THE PERIOD 1988-1995

The analysis of fiscal policy stance in Chapter II of this paper made an overall classification of stance as expansionary or contractionary depending on the results obtained with a simple indicator of fiscal policy discretionary action -the fiscal impulse. However, the complexity of fiscal policy is on such a scale as not to fit perfectly into indicators as composite as those used. In effect, a detailed analysis of fiscal policy reveals it to be actually made up of an often contradictory set of legislative and administrative measures that affect the various revenue and expenditure captions. As shown in the adjoining tables (which detail expansionary and contractionary discretionary measures on the revenue and expenditure sides), it is difficult given this complex set of provisions to classify fiscal policy in a given year as "expansionary" or "contractionary": indeed, each year sees a complex mix of measures of which a conspectus cannot be readily made.

Notwithstanding, the adjoining tables do enable certain general features to be observed. Notable in 1988, for instance, was the absence of expansionary measures on the expenditure side, while in 1989 there was evidently a discretionary increase in public spending, partly financed by tax increases. Moreover, 1992 was clearly a year of fiscal policy containment. 1993 was one of confusion and change with all sorts of measures, some contractionary, most expansionary, on both the revenue and expenditure sides, while 1994 was noteworthy for contractionary conduct on the expenditure side. Added also is a table summarising the main measures in the 1995 Budget, along with those other measures taken previously but which could have a bearing in 1995; logically, however, it is not known what the final impact of all these measures will be.

In any event, when interpreting the effect of the measures detailed in the year tables, several issues should be taken into account. First, and evidently, not all measures have the same impact: it is not possible to compare the various measures without having some vague, approximate idea about what these represent in monetary terms. An analysis of the

TABLE A.1.1

1988

CONTRACTIONARY MEASURES	
<i>Increase in revenue</i>	<i>Reduction in expenditure</i>
Social security contributions — Increase of one point in contribution rate for Special Regime for Household Service Employees. Excise duties — Increase in rates (alcohol, beer and tobacco).	Compensation of employees — Wage rise of 4 %. Net purchases — Cut in military investment and in current expenditure by the Ministry of Defence. Interest — Assumption of investment certificates by the ICO (Official Credit Institute). — Fall, in 1987, in average rates at issue on Treasury notes. Pensions — Revaluation of the order of half a point below inflation.
EXPANSIONARY MEASURES	
<i>Reduction in revenue</i>	<i>Increase in expenditure</i>
Personal income tax — Increase in revenue in 1987, not matched in 1988, further to Royal Decree 2535/1986, which introduced monthly periodicity in earned-income withholdings for small and medium-sized companies and increased capital withholdings and partial tax payments for business activities. — 5 % reduction in the tax schedule scale. — Reduction in withholdings on earned income for remuneration less than PTA 2 million (RD 9 dated January 15 1988). Taxes related to imports — Lowering of tariff barriers vis-à-vis the EC. Social security contributions — Reduction of three-tenths of a point in the contribution rate to FOGASA (Wage Guarantee Fund). — Lesser increase in the minimum and maximum contribution bases (lower than forecast inflation).	

1989

CONTRACTIONARY MEASURES	
<i>Increase in revenue</i>	<i>Reduction in expenditure</i>
<p>Personal Income Tax</p> <ul style="list-style-type: none"> — Transfer to 1990 of refunds relating to excess tax paid totalling PTA 325 billion (as a result of Constitutional Court ruling 45/89). — Increase in capital income withholdings, and subjection of financial accounts in Treasury bills, asset repos and single-premium insurance policies (Royal Legislative Decree 5 dated July 7 1989). — Effect on net tax payable/refundable of the reduction in withholdings on earned income applied in 1988 pursuant to RD 9/88. <p>Corporate income tax</p> <ul style="list-style-type: none"> — Increase in the number of prepayments and in the overall amount thereof (30% – 55 %). — Increase in capital income withholdings, and subjection of financial accounts in Treasury bills, asset repos and single-premium insurance policies (RLD 5/89). <p>Taxes related to imports</p> <ul style="list-style-type: none"> — Increase in the Common External Tariff. <p>Excise duties</p> <ul style="list-style-type: none"> — Increase in rates on alcohol, beer and tobacco. <p>Social security contributions</p> <ul style="list-style-type: none"> — Increase in rates for Agricultural and Household Service Special Regimes. — Unification of categories for maximum-base purposes. 	<p>Compensation of employees</p> <ul style="list-style-type: none"> — Wage rise of 4 %. <p>Investment and transfers (current and capital)</p> <ul style="list-style-type: none"> — PTA 193 billion reduction of credits (RDL 3/89). <p>Investment and capital transfers</p> <ul style="list-style-type: none"> — Additional adjustment to RLD 3/89 totalling PTA 114.6 billion. <p>Capital transfers</p> <ul style="list-style-type: none"> — Reduction of PTA 60 billion in connection with reconversion and reindustrialisation plans, and of PTA 65 billion for iron and steel industry measures agreed with the EC.
EXPANSIONARY MEASURES	
<i>Reduction in revenue</i>	<i>Increase in expenditure</i>
<p>Taxes related to imports</p> <ul style="list-style-type: none"> — Lowering of tariff barriers vis-à-vis the EC. <p>Excise duties</p> <ul style="list-style-type: none"> — Reduction in hydrocarbons rates. <p>Social security contributions</p> <ul style="list-style-type: none"> — Reduction in contribution rate to FOGASA (Wage Guarantee Fund). 	<p>Compensation of employees</p> <ul style="list-style-type: none"> — Additional payments in April and May totalling PTA 23.9 billion to increase civil servants' purchasing power (RLD 3/89). — Additional revaluation of retiree pensions (RLD 3/89). — 7 % growth in staffing. <p>Unemployment</p> <ul style="list-style-type: none"> — Extension of eligibility to the long-term unemployed, with special consideration for those aged over 45 with dependents, for a cost of PTA 81.1 billion (RLD 3/89). <p>Contributory pensions</p> <ul style="list-style-type: none"> — Additional revaluation, costing PTA 28.7 billion (RLD 3/89). — Equating of minimum pension with legal minimum wage, costing PTA 47.1 billion in 1989 (RLD 3/89). — Additional payment for the Agricultural, Household Service and Self-Employed Regimes. <p>Welfare assistance pensions and LISMI (benefits relating to the Law on the social integration of the mentally and physically handicapped).</p> <ul style="list-style-type: none"> — Improvement in benefits for a cost of PTA 10.7 billion (RLD 3/89). <p>Capital transfers</p> <ul style="list-style-type: none"> — Early repayment of INI (State Industrial Holding Company) and FORPPA (Agricultural Price and Product Regulation Fund) debts assumed by the State (PTA 187.7 billion more than in 1988).

TABLE A.1.3

1990

CONTRACTIONARY MEASURES	
<i>Increase in revenue</i>	<i>Reduction in expenditure</i>
<p>Personal income tax — Increase in capital income withholdings and subjection of specific financial assets (RLD 5/89), effective in the period January-August.</p> <p>Corporate income tax — Increase in prepayment amounts (55% 60 %). — Increase in capital income withholdings and subjection of specific financial assets (RLD 5/89), effective in the period January-August.</p> <p>Taxes related to imports — Increase in the Common External Tariff.</p> <p>VAT — Delay in VAT refunds for fiscal year 1990.</p> <p>Excise duties — Increase in rates (hydrocarbons and tobacco).</p> <p>Social security contributions — Increase in rates for the Agricultural Special Regime.</p>	<p>Compensation of employees — Wage increase of 6 %.</p> <p>Interest — Decline in average rates at issue on Treasury notes.</p> <p>State expenditure — Introduction of a ceiling on the growth of committed spending (article 10 of Budget Law).</p>
EXPANSIONARY MEASURES	
<i>Reduction in revenue</i>	<i>Increase in expenditure</i>
<p>Personal income tax — Greater net effect of transfers from one year to the next of refunds for excess net tax paid. — Deflation of the fiscal 1989 schedule and of earned income withholdings.</p> <p>Corporate income tax — Effect of increase in prepayments in 1989 on net tax payable/refundable.</p> <p>Taxes related to imports — Lowering of tariff barriers vis-à-vis the EC.</p> <p>VAT — Increase in VAT paid to the EC totalling PTA 38 billion, corresponding to the settlement of fiscal years 1988 and 1989.</p> <p>Social security contributions — Decline in contribution rate to FOGASA (Wage Guarantee Fund).</p>	<p>Compensation of employees — Payroll payment of PTA 52,525 to civil servants (RLD 1/90). — Agreement to introduce automatic-inflation-adjustment clause into wages (with effect in 1991 and 1992 as well).</p> <p>Pensions — Revaluation above inflation. — Agreement to revalue on the basis of the November-on-November CPI of previous year (with effect in 1991, 1992 and 1993).</p>

TABLE A.1.4

1991

CONTRACTIONARY MEASURES	
<i>Increase in revenue</i>	<i>Reduction in expenditure</i>
<p>Personal income tax — Lesser net effect of transfers from one year to the next of refunds for excess net tax paid.</p> <p>Taxes related to imports — Rise in the Common External Tariff.</p> <p>VAT — Reduction of VAT return to EC (25 % 5 %).</p> <p>Excise duties — Rise in hydrocarbons rates.</p> <p>Social security contributions — Rise in rates for Agricultural Special Regime.</p>	
EXPANSIONARY MEASURES	
<i>Reduction in revenue</i>	<i>Increase in expenditure</i>
<p>Personal income tax — Net effect of deflation of schedules and withholding tables on earned income (with different lags) in fiscal years 1990 and 1991. — Exemption from withholdings of capital income received by non-residents. — Introduction of optional tax allocation to the Catholic Church. — Effect on the net tax collected in 1991 of the increase in withholdings on capital returns, which affected takings related to this item in the period January-August 1990.</p> <p>Corporate income tax — Effect of the increase in prepayments in 1990 on net tax.</p> <p>Taxes related to imports — Lowering of tariff barriers vis-à-vis the EC.</p> <p>VAT — Delay in VAT refunds for 1990. — VAT adjustment 90/91, Navarre region (Law 28/90).</p> <p>Social security contributions — Lowering of rates for the Self-Employed Special Regime.</p>	

TABLE A.1.5

1992

CONTRACTIONARY MEASURES	
<i>Increase in revenue</i>	<i>Reduction in expenditure</i>
<p>Personal income tax</p> <ul style="list-style-type: none"> — Lesser net effect of transfers from one year to the next of refunds for excess net tax paid. — Change in objective-estimation procedure and in calculation of partial payments (RD 1841 dated December 30th 1991). — Effect to net tax raised in 1991 of the rise to 25 % in withholdings on capital income, which began to be applied in August 1989 and which therefore affected takings for this item during the period January-August 1990. — Introduction of the optional tax allocation to the Catholic Church, which affected 1991 revenue for the first time. <p>VAT</p> <ul style="list-style-type: none"> — Rises of one and two points in January and August, respectively, in the standard rate. — Delay in fiscal 1992 refunds. <p>Excise duties</p> <ul style="list-style-type: none"> — Changes in rates in January 1992 (hydrocarbons and tobacco). <p>Social security contributions</p> <ul style="list-style-type: none"> — One-point rise in contribution rate relating to unemployment; increases in Agricultural Special Regime of 0.75 points for self-employed workers and 0.5 points for dependent employees. 	<p>Compensation of employees</p> <ul style="list-style-type: none"> — Freeze in public-sector offers of employment (RDLD 5/92, urgent budgetary measures). <p>Unemployment</p> <ul style="list-style-type: none"> — Effects of RLD 1 dated April 3rd 1992, which reduced the amount and duration of the contribution-based benefit and raised the number of months' contributions required for entitlement to this benefit. <p>Temporary labour disability</p> <ul style="list-style-type: none"> — Transfer to employers of related expenses incurred from day three to fifteen after disability arises (RLD 5 dated July 21st 1992). <p>Health care benefits</p> <ul style="list-style-type: none"> — Control of fraud in Social Security medication allowance for pensioners and other groups (RDLD 5/92, urgent budgetary measures).
EXPANSIONARY MEASURES	
<i>Reduction in revenue</i>	<i>Increase in expenditure</i>
<p>Personal income tax</p> <ul style="list-style-type: none"> — Change in withholdings table applicable to earned income obtained in 1992, contained in RD 1841 dated December 30th 1991, which approves the new personal income tax regulations. This lowering of withholdings was partly adjusted by RLD 5 dated July 21 st 1992 (under urgent budgetary measures). — New treatment of capital income which, in Law 18 dated June 6th 1991, entailed a deviation by saving towards assets exempt from withholding tax. — Deflation of the 1991 personal income tax schedule, affecting the net tax collected in 1992. <p>Taxes related to imports</p> <ul style="list-style-type: none"> — Lowering of tariff barriers vis-à-vis the EC. <p>VAT</p> <ul style="list-style-type: none"> — Reduction of top rate (33 % 28 %). 	<p>Compensation of employees</p> <ul style="list-style-type: none"> — Wage rise of 5 % and application of the automatic-inflation-adjustment clause to wages. <p>Net purchases</p> <ul style="list-style-type: none"> — Restatement of Social Security liabilities prior to 1992. <p>Contributory pensions</p> <ul style="list-style-type: none"> — Revaluation of minimum pensions. — Extra payment for Household-Service and Self-Employed regimes. <p>Non-contributory pensions</p> <ul style="list-style-type: none"> — Effects of their introduction pursuant to Law 26/90. <p>Interest</p> <ul style="list-style-type: none"> — Tendency towards Treasury financing under closer-to-market conditions.

TABLE A.1.6

1993

CONTRACTIONARY MEASURES	
<i>Increase in revenue</i>	<i>Reduction in expenditure</i>
Personal income tax <ul style="list-style-type: none"> — Modification (with back-dated effect) of the personal income tax schedule for fiscal year 1992, and delay in the correction of the withholdings table applicable to earned income that year. — No deflation of the withholdings table in 1993. — Deviation by saving towards assets exempt from withholding tax as a result of the entry into force in 1992 of Law 18 dated June 6th 1991, reforming personal income tax. — Introduction of new sectors into the module-based objective-estimation modality. Taxes related to imports <ul style="list-style-type: none"> — Introduction of general sales tax in the Canary Islands. Excise duties <ul style="list-style-type: none"> — Creation of special duties on certain means of transport. — Modification of rates in January 1993 (alcohol, beer and tobacco). — Modification of rates in August 1993 (hydrocarbons). Social security contributions <ul style="list-style-type: none"> — Rise of 0.5 points in the General Regime rate, of 0.5 points and 0.75 points, respectively, in the Agricultural Special Regimes for dependent workers and the self-employed, and of 0.16 points in the Self-Employed Regime. — Raising of the maximum contribution bases of groups 5 to 11. — Reduction of rebates for employment promotion (RLD 1 dated April 3rd 1992). 	Compensation of employees <ul style="list-style-type: none"> — Wage rise of 1.8 %. — Staff reductions in State sector. — Restatement of Social Security liabilities prior to 1992 for a lesser amount than in that year. Unemployment <ul style="list-style-type: none"> — Effects of RLD dated April 3rd 1992, which cut the amount and duration of the contributory benefit and increased the number of months' contributions required for entitlement to this benefit. Temporary labour isability <ul style="list-style-type: none"> — Transfer to employers of related expenses incurred from day four to fifteen after disability arises (RLD 5 dated July 21st 1992). Health care benefits <ul style="list-style-type: none"> — RD 83/93 on selective financing of medication.
EXPANSIONARY MEASURES	
<i>Reduction in revenue</i>	<i>Increase in expenditure</i>
Personal income tax <ul style="list-style-type: none"> — Greater net effect of transfers from one year to the next of refunds for excess net tax paid. — Change in 1992 in the objective-estimation procedure and in the calculation of partial payments (RD 1841 dated December 30th 1991). — Reduction of partial payments in module-based objective-estimation procedure (RLD 3 dated February 26th 1993). Corporate income tax <ul style="list-style-type: none"> — Increase in tax allowance for R+D spending and for exportation. Taxes related to imports <ul style="list-style-type: none"> — Lowering of tariff barriers vis-à-vis the EC. VAT <ul style="list-style-type: none"> — Lowering of rates in January 1993 (28 % 15 %, 6 % 3 %), in contrast to the rises effected in 1992. — New treatment of intra-Community transactions. — Delay in refunds for fiscal year 1992. Excise duties <ul style="list-style-type: none"> — Change in filing period (alcohol and beer). 	Unemployment <ul style="list-style-type: none"> — Promotion of part-time, fixed-term hiring (RLD 3 dated February 26th 1993). Contributory pensions <ul style="list-style-type: none"> — Application of the revaluation agreement. Non-contributory pensions <ul style="list-style-type: none"> — Effects of their introduction by Law 26/90. Interest <ul style="list-style-type: none"> — Tendency towards Treasury financing under closer-to-market conditions. Subsidies <ul style="list-style-type: none"> — Subsidy to RTVE (State Broadcasting Corporation). Net purchases, investment and transfers (current and capital) by the State <ul style="list-style-type: none"> — Annulment of article 10 of the Budget Law, which set a ceiling on the growth of committed spending.

1994

CONTRACTIONARY MEASURES	
<i>Increase in revenue</i>	<i>Reduction in expenditure</i>
<p>Personal income tax</p> <ul style="list-style-type: none"> — No deflation of the withholdings table. — Subjection to taxation of the contributory unemployment benefit and partial and complete permanent labour disability pensions. — Lesser net effect of transfers from one year to the next of refunds for excess net tax paid. — Change in 1992 in objective-estimation procedure, having a bearing on 1993 revenue. — Lesser reduction of partial payments in module-based objective-estimation procedure, in relation to that introduced pursuant to RLD 3/93 of February 26th, offset by the appearance of a reducing coefficient per staff employed. <p>Corporate income tax</p> <ul style="list-style-type: none"> — Elimination of the PTA 500,000 allowance for job creation. <p>VAT</p> <ul style="list-style-type: none"> — New treatment of intra-Community transactions, entailing a transfer of revenue from 1993 to 1994. — Delay in refunds from fiscal year 1992. <p>Excise duties</p> <ul style="list-style-type: none"> — Modification of rates in August 1993 (hydrocarbons). — Modification of rates in January 1994 (alcohol, beer and tobacco). — Change in filing period in 1993 (alcohol and beer). <p>Social security contributions</p> <ul style="list-style-type: none"> — Rise of 0.5 points in the contribution rate payable by employees relating to unemployment. 	<p>Compensation of employees</p> <ul style="list-style-type: none"> — Wage freeze. — Staff reduction in State sector. <p>Unemployment</p> <ul style="list-style-type: none"> — Transfer to the unemployed of their portion of the related contribution to Social Security Funds. — Restricting of access to unemployment subsidy via lowering of income ceiling below which entitlement arises. — Reduction of the amount of the subsidy and of the maximum and minimum limits of the contributory benefit. <p>Temporary labour disability</p> <ul style="list-style-type: none"> — Transfer to employers of related expenses incurred from day four to fifteen after disability arises (RLD 5 dated July 21st 1992). <p>Contributory pensions</p> <ul style="list-style-type: none"> — Revaluation based on forecast inflation (lower than actual inflation) <p>Health care benefits</p> <ul style="list-style-type: none"> — Reduction of the selling price of medication. — Discounts agreed on with Official Pharmacists' Associations.
EXPANSIONARY MEASURES	
<i>Reduction in revenue</i>	<i>Increase in expenditure</i>
<p>Personal income tax</p> <ul style="list-style-type: none"> — Modification with back-dated effect of the personal income tax schedule for fiscal year 1992, and delay in the adjustment of the withholdings table applicable to income from work that year. — Effect of "coupon-washing" operations as a result of the tax exemption accorded to yields on government debt held by non-residents, introduced pursuant to RLD 5 dated December 20th 1990 (under urgent fiscal measures). — Change in procedure for calculating partial payments under the direct-and coefficient-based objective-estimation modalities, further to a Supreme Court ruling of November 12th 1993. <p>Corporate income tax</p> <ul style="list-style-type: none"> — Increase in fiscally admissible depreciation for new fixed assets (RLD 3 dated February 26 1993). — Elimination of limit on carryforward of negative tax bases for new companies). — New depreciation tables (Ministerial Order dated May 12th 1993). <p>VAT</p> <ul style="list-style-type: none"> — Extension to specific sectors of the special rapid-refund procedure (RLD 1811 dated September 2nd 1994). <p>Excise duties</p> <ul style="list-style-type: none"> — Incidence of RENOVE plans (government-sponsored incentive scheme to stimulate new car sales) on tax on certain means of transport, virtually offset by increased sales induced by these plans. 	<p>Non-contributory pensions</p> <ul style="list-style-type: none"> — Effects of their introduction pursuant to Law 26/90. <p>Interest</p> <ul style="list-style-type: none"> — Tendency towards Treasury financing under closer-to-market conditions (prohibition of recourse to the Banco de España).

1995

CONTRACTIONARY MEASURES	
<i>Increase in revenue</i>	<i>Reduction in expenditure</i>
Personal income tax <ul style="list-style-type: none"> — Lesser reduction of partial payments in module-based objective-estimation procedure, in relation to that introduced in 1994, and inclusion of new sectors in this modality. — Effect of the change in procedure for calculating partial payments under the direct- and coefficient-based objective-estimation modalities. VAT <ul style="list-style-type: none"> — One-point increase in applicable rates. Excise duties <ul style="list-style-type: none"> — Increase in rates (hydrocarbons, alcohol, beer and tobacco). 	Compensation of employees <ul style="list-style-type: none"> — Wage rise of 3.5 %. Contributory pensions <ul style="list-style-type: none"> — Revaluation based on forecast inflation. Temporary labour disability and provisional invalidity <ul style="list-style-type: none"> — Fusion into a single concept and reduction of the maximum duration of the benefit.
EXPANSIONARY MEASURES	
<i>Reduction in revenue</i>	<i>Increase in expenditure</i>
Personal income tax <ul style="list-style-type: none"> — Deflation of withholdings table. — Subjection to taxation, from 1994 onwards, of the contributory unemployment benefit and partial and complete permanent labour disability pensions. Corporate income tax <ul style="list-style-type: none"> — Increase in fiscally admissible depreciation for new fixed assets (RLD 3 dated February 26th 1993). — Elimination of limit on carryforward of negative tax bases for new companies (RLD 3 dated February 26th 1993). — Rebate for newly created small and medium-sized firms (Law 22 dated December 29th 1993). — Accelerated depreciation relating to job creation (RLD 7 dated June 20th 1994). — Creation of a 5 % tax allowance for industrial training expenses, increase in the allowance for investment abroad and raising of the maximum limit governing investment tax deductions applicable to net tax payable (1994 Budget Law). VAT <ul style="list-style-type: none"> — Extension to specific sectors of the special rapid-refund procedure (RLD 1811 dated September 2nd 1994). — Deduction, in the period in which they are accrued, of VAT borne on intra-Community transactions (Law 42 dated December 30th 1994). Excise duties <ul style="list-style-type: none"> — One-point reduction in the rate of the tax applicable to certain means of transport. — Incidence of RENOVE-II plans (second government-sponsored incentive scheme to stimulate new car sales) on tax on certain means of transport. Social security contributions <ul style="list-style-type: none"> — One-point reduction in the General Regime rate (0.8 points corresponding to employer's portion, and 0.2 points to that of the employee). — Cut of 0.8 points in the Special Regime rate for the Self-Employed, and of one point in the special regimes for maritime and coal workers. 	Contributory pensions <ul style="list-style-type: none"> — Compensation for greater inflation in 1994. Non-contributory pensions <ul style="list-style-type: none"> — Effects of their establishment pursuant to Law 26/90. Health care assistance <ul style="list-style-type: none"> — Reform of funding arrangements, departing from a calculation base that corresponds to actual expenditure (outturn + debts), although the INSALUD (the Spanish public health service) budget appropriation ceases to be enlargeable.

budgetary impact of each action is beyond the scope of this paper (it is, in fact, a virtually impossible task). Consequently, in Table A.1.9., we confine ourselves to offering a more detailed analysis [and with an alternative technique to that used in Chapter II (1)] of the discretionary component of different revenue and expenditure captions. Secondly and lastly, these discretionary measures may have a very lagging budgetary effect that spreads over several years. That makes it difficult both to ascribe them to a specific year and to make a quantitative calculation. Such was the case of the extending of unemployment benefits in 1989, which started to show its high cost as the slowdown in activity progressively raised unemployment and labour turnover.

As stated, Table A.1.9 attempts to show the overall impact that the various discretionary measures taken between 1988 and 1993 may have had on revenue and expenditure captions. Outlined below are the conclusions obtained from the analysis of this table:

- The results obtained in Chapter II on fiscal policy stance are confirmed: it is expansionary throughout the period except in 1989, 1992 and 1994 (though in 1989 the result is once more distorted due to the transfer of personal income tax refunds to 1990).
- The contractionary nature of revenue in 1989, 1990 (once adjusted for the transfer of personal income tax refunds from 1989 to 1990), 1991 and 1992 (the most contractionary year taxwise) is confirmed. Regarding taxes:
 - Personal income tax is contractionary every year except in 1990, 1993 and 1994. Its contractionary nature in 1992 is, in principle, surprising in the light of the personal income tax reform entering into force that year, although the cost of the reform may have had a more intense bearing on 1993.
 - Corporate income tax appears to have been expansionary since 1991. This result is more indicative of the problems prevailing in capturing the high cyclical component of this tax than it is of discretionary measures. The expansionary character in 1988 is attributable to a mere accounting effect (a change in the calculation of withholdings on capital between personal and corporate income tax).
 - Taxes related to imports, which are systematically expansionary, reflect the effect of the lowering of tariff barriers following EU membership.

(1) Both are described in Appendix 2.

TABLE A.1.9

GENERAL GOVERNMENT
DISCRETIONARY AND STRUCTURAL CHANGES IN THE DEFICIT (a)
% of GDP

	1988	1989	1990	1991	1992	1993	1994
Revenue	-0.367	1.654	-0.352	0.167	1.846	-0.198	-0.145
Personal income tax (b)	0.128	0.746	-0.349	0.563	0.711	-0.111	-0.238
Corporate income tax (b)	-0.110	0.833	0.095	-0.428	-0.289	-0.239	-0.310
Taxes linked to imports	-0.064	-0.165	-0.165	-0.135	-0.146	-0.170	-0.033
VAT	-0.041	0.293	-0.475	-0.051	0.467	-0.583	0.300
Excise duties and other	-0.047	-0.216	0.184	0.112	0.127	0.363	0.188
Social security contributions	-0.351	0.187	0.193	0.200	0.941	0.510	-0.028
Other revenue	0.118	-0.025	0.165	-0.096	0.036	0.032	-0.022
Expenditure	0.240	1.618	1.297	1.435	0.621	2.312	-0.953
Compensation of employees	0.138	0.283	0.473	0.392	0.619	-0.185	-0.226
Net purchases	-0.383	0.215	-0.026	0.156	0.074	0.326	-0.143
Welfare benefits	0.144	0.159	0.522	0.826	0.783	0.522	-0.146
<i>Unemployment</i>	<i>-0.049</i>	<i>0.026</i>	<i>0.141</i>	<i>0.359</i>	<i>0.237</i>	<i>0.230</i>	<i>-0.335</i>
<i>Pensions</i>	<i>0.094</i>	<i>0.108</i>	<i>0.192</i>	<i>0.138</i>	<i>0.218</i>	<i>0.379</i>	<i>0.321</i>
<i>Temporary labour disability</i>	<i>0.027</i>	<i>0.058</i>	<i>0.064</i>	<i>0.075</i>	<i>0.015</i>	<i>-0.100</i>	<i>-0.067</i>
<i>Other</i>	<i>0.071</i>	<i>-0.034</i>	<i>0.125</i>	<i>0.254</i>	<i>0.313</i>	<i>0.014</i>	<i>-0.064</i>
Interest	-0.103	0.133	0.272	0.205	0.240	0.977	0.080
Subsidies	0.268	-0.080	-0.050	-0.111	-0.117	0.272	-0.047
Investment	0.415	0.622	0.612	-0.109	-0.784	-0.032	-0.308
Other expenditure	-0.238	0.287	-0.507	0.077	-0.195	0.432	-0.163
Deficit	-0.607	0.036	-1.648	-1.268	1.226	-2.511	0.809

Sources: Ministerio de Economía y Hacienda, Banco de España and own calculation.

(a) Defined as net lending (+) or net borrowing (-).

(b) In 1988 there was a change in the allocation of revenue relating to capital income withholdings, leading to a transfer of such revenue from corporate to personal income tax.

- VAT is contractionary in 1989 and, above all, in 1992 (when the standard rate was raised three points). In 1993, the expansionary nature is due to atypical elements (such as legislative harmonisation or the impact on VAT takings of the disappearance of intra-Community customs borders) which, in turn, explain the contractionary impulse in 1994. In general, this tax evidences a slide over the medium term in its revenue-raising performance, perhaps reflecting tax fraud problems.
- Excise duties are contractionary in all years except 1988 and 1989 (the rates of the tax on hydrocarbons were cut in this latter year), reflecting the tax increases associated with harmonisation with the EU.

- Social security contributions are also contractionary in all years except 1988 (when the increases in the minimum and maximum bases were limited) and 1994.
- Regarding expenditure, their persistent expansionary stance to 1993 is confirmed.
- Employee compensation is on a clearly expansionary line to 1993, whereafter it turns slightly contractionary.
 - Net purchases, evidencing high volatility, exhibit a slightly expansionary behaviour overall.
 - Social security benefits are on an increasingly expansionary line until 1993. Caption by caption, unemployment displays slightly contractionary behaviour in 1988 and expansionary behaviour in the remaining years, not re-adopting a contractionary stance until 1994 (despite the cut in benefits in 1992). That reflects the problems that may arise in the computation of the discretionary elements of expenditure (in this case due to the lag with which the measures act and to the difficulties of adjusting for the cycle when the correlation between employment and income increases at the height of a crisis). As to pensions, their biggest expansionary impulse is between 1992 and 1994, reflecting, more than discretionary measures, the scant -or non-existent- cyclical sensitivity of pensions spending, which boosts its weight in terms of GDP in recessionary periods.
 - The expansionary behaviour of interest reflects the increase in financing at market prices, with the subsequent increase in the average cost of outstanding public debt.
 - Subsidies evidence a contraction as from 1989, ending with the sharp expansion of 1993 and resuming in 1994. This pattern reflects the heyday of the economic climate and the freeze on public corporation transfers in these years.
 - Lastly, investment changes from expansionary in the 1988-1990 period to contractionary as from 1991, this contraction proving especially sharp in 1992.

APPENDIX 2

METHODS OF COMPUTING FISCAL POLICY DISCRETIONARY ACTION

This paper has employed a fiscal policy indicator which adjusts for the effect of the cycle on the fiscal variables of revenue and expenditure, thus allowing the fiscal policy stance to be measured. This indicator reveals the reaction of the economic authorities to changes in the economic environment and acts as a leading indicator of fiscal policy.

Generally, and from a theoretical standpoint, a fiscal policy stance indicator would be of the type:

$$IFP = h (FP_2 - FP_1) \quad [A.I]$$

where h is the multiplier of the reduced form of a model of the form:

$$Y = a + bX + cY_{-1} + hFP + dOF \quad [A.II]$$

where Y , X , Y_{-1} , FP and OF are, respectively, the endogenous (e.g. GDP), exogenous (e.g. GDP of the rest of the world) and lagged endogenous variables, the fiscal policy variable and other economic policy variables (e.g. monetary policy), and where FP_2 and FP_1 are the two fiscal policies we wish to compare.

However, a desirable characteristic of any indicator is that it should not depend on given theoretical models. This is something common to the indicators usually used (in particular those developed by the IMF and the OECD), that do not have an underlying model. This has the advantage of uncoupling the indicator from controversial assumptions; but its results need not as a consequence differ significantly from those that would be obtained using theoretical models (1).

(1) See, for instance, MacKenzie (1988). *Are all summary indicators of the stance of fiscal policy misleading?*; WP/IMF, 88/112, International Monetary Fund.

A.2.1. The IMF fiscal impulse

The IMF defines the concept of the cyclical effect of the budget (CEB) as (2):

$$CEB_t = CNB_t - ABB_t \quad [A.III]$$

CNB being the cyclically neutral budget balance and ABB the actual budget balance of public-sector transactions (i.e. the public deficit or surplus). Likewise, the cyclically neutral balance is defined as:

$$CNB_t = (TR_0/GDP_0) \cdot GDP_t - (S_0/GDP_0^p) \cdot GDP_t^p \quad [A.IV]$$

TR being general government revenue, S general government spending and GDP^p real potential GDP multiplied by the GDP deflator at market prices. The subscript 0 indicates the base year, and the subscript t the year analysed.

To interpret the CNB indicator, definition [A.IV] should be re-written as:

$$CNB_t = \frac{GDP_t^p}{GDP_0^p} (TR_0 - S_0) + TR_0 \left(\frac{GDP_t}{GDP_0} - \frac{GDP_t^p}{GDP_0^p} \right) \quad [A.V]$$

The first addend is the potential neutral balance, i.e. that balance which maintains in year t the same pressure on potential output as that exerted by the budgetary policy of the base year. The second addend captures the cyclical effect of GDP growth on tax revenue. If the economy does not grow at its potential rate, revenue will be less than potential. The CNB definition considers as neutral a fall in revenue equal to the product of the difference between real and potential growth rates and the total revenue of the base year. When $GDP_0 = GDP_0^p$, the fall in neutral revenue is that presented by unit elasticity with respect to the difference between potential GDP and that actually recorded.

Thus, CNB is the budget balance that would have been obtained had the relationship between public spending and potential GDP held at the same level as in the base year, and if public revenue had accounted for the same proportion in terms of real GDP as in the base year. A positive CEB will denote an expansion of fiscal policy in relation to the base year, and vice-versa.

(2) See Heller, P.S.; R.D.Haas and A.H.Mansur (1986). *A Review of the Fiscal Impulse Measure*. Occasional Paper, 44, Washington, International Monetary Fund.

To limit the dependence of this indicator (of its level in particular) on the year taken as a base, the fiscal impulse indicator is defined, as a percentage of GDP, as:

$$FI_t = - \left(\frac{CEB}{GDP} \right)_t = - \left(\frac{CEB}{GDP} \right)_t + \left(\frac{CEB}{GDP} \right)_{t-1} \quad [A.VI]$$

Thus, if $FI > 0$, fiscal policy has been comparatively less expansionary than that of the previous year, i.e. the fiscal impulse will have been contractionary.

Before concluding, a characteristic aspect of this indicator that might go unnoticed should be stressed. We refer to the fact that the entire effect exerted by progressivity on revenue is attributed to the discretionary action of fiscal policy. Since in a cyclical upturn revenue grows more quickly than GDP, due to the fact the tax system is progressive, when the revenue/GDP ratio (as opposed to the revenue/potential GDP ratio) is taken as a reference, the increase in revenue associated with such progressivity is considered as a discretionary element; really, however, it is an effect that arises automatically once the discretionary decision to apply progressive taxes has been adopted. In any event, this enables the fiscal conduct of countries with different sets of built-in stabilisers to be compared.

A.2.2. Other alternative procedures

Alternatively, the budget balance and each of the revenue and expenditure captions making it up can be broken down into a permanent or trend component and into a transitory component, which may be either of cyclical origin or discretionary. Three components are thus obtained for each budgetary caption: trend, cyclical and a residual incorporating all those non-cyclical components that have a transitory effect on the deficit.

The trend component has been extracted applying to each caption of the public accounts, expressed as a percentage of GDP, a Hodrick-Prescott filter taking —as for the calculation of potential GDP—a lambda equal to 5.

The basis chosen for calculating the cyclical component was a definition of the cyclically neutral balance (CNB*) modifying that of the IMF, and introducing a cyclical impact on revenue:

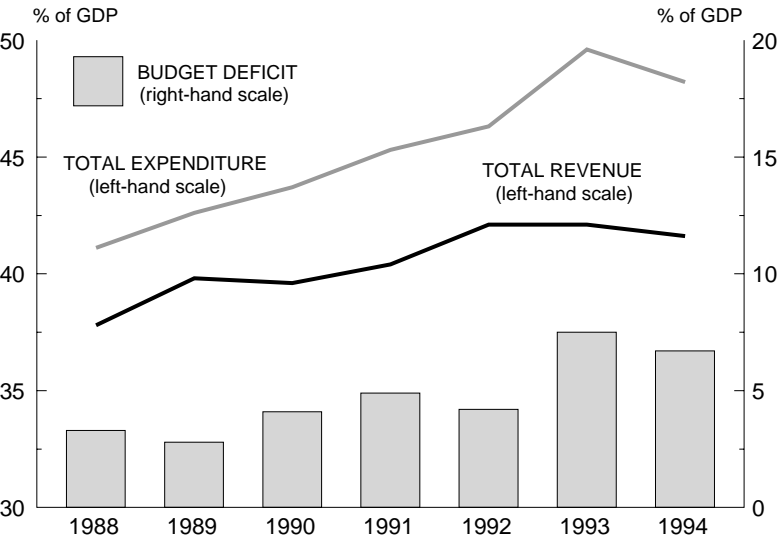
$$CNB_t^* = \left(\frac{TR_o}{GDP_o} \right) \left(\frac{GDP_t}{GDP_t^p} \right) - \left(\frac{S_o}{GDP_o^p} \right) \left(\frac{GDP_t^p}{GDP_t} \right) \quad [A.VII]$$

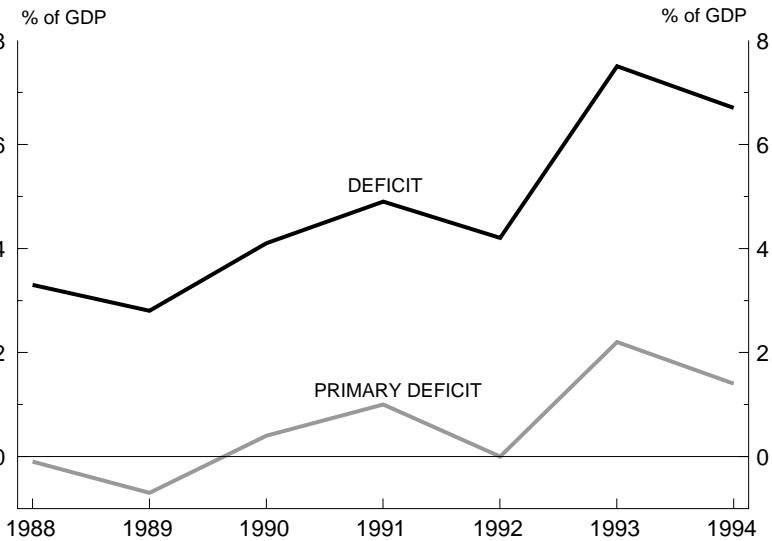
where the symbols are as previously indicated. To alleviate the dependence of this measurement on the year taken as a base, the average of a sufficiently long period (1964-1994 in our case) is used as a base. Then, to eliminate this dependence as regards the level, a regression of the changes in the cyclical component of real GDP has been made on the changes in the cyclical balance, thus defined. Finally, the coefficient of this regression has been applied to the cyclical component (in levels) of real GDP to obtain the cyclical component of the budget balance.

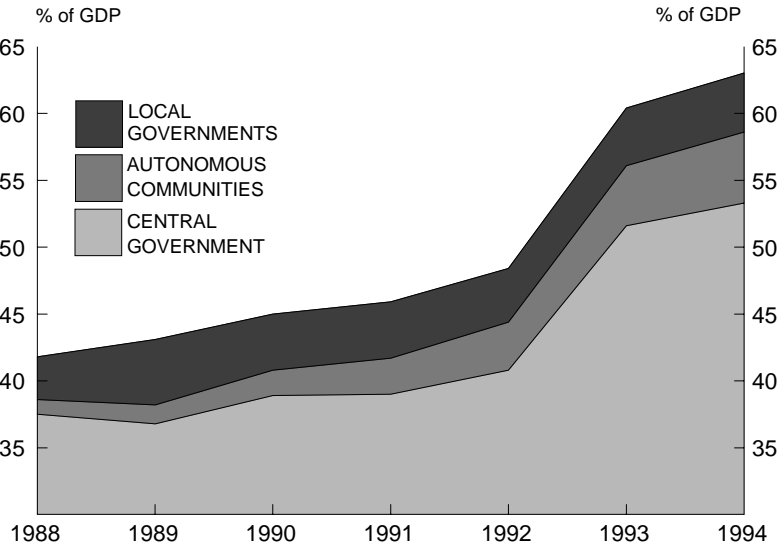
If the changes in the trend component and in the cyclical component thus calculated are taken away from the changes in the actual budget balance, we obtain the residual changes in the budget balance, which capture the cyclical incidence of discretionary measures and of other types of non-cyclical factors (accounting lags, administrative decisions on spending or on revenue terms). Table A.1.9 gives the sum of these residual changes and of the trend changes for the main revenue and expenditure captions.

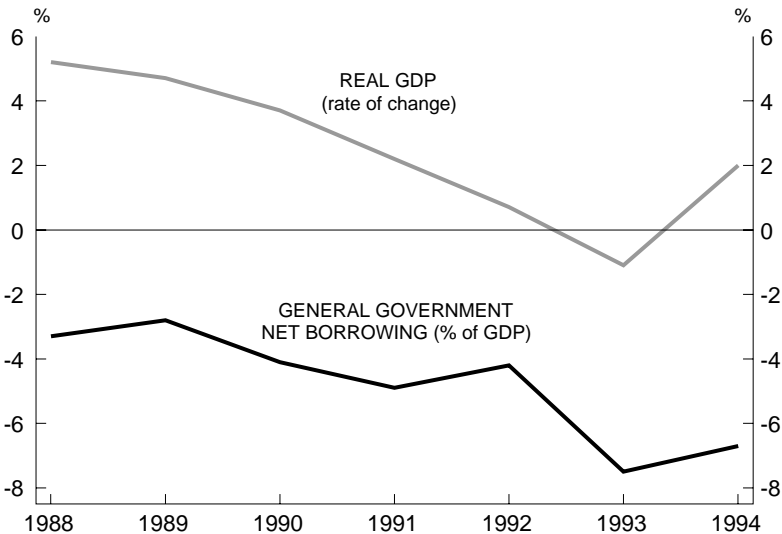
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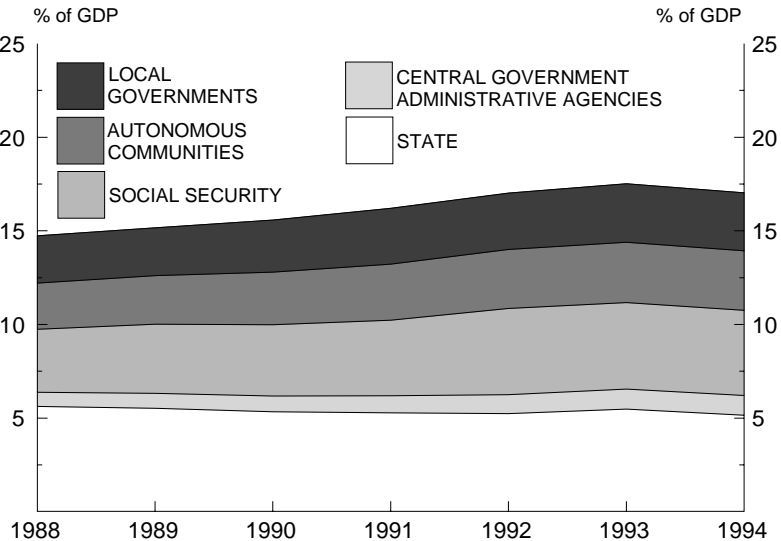
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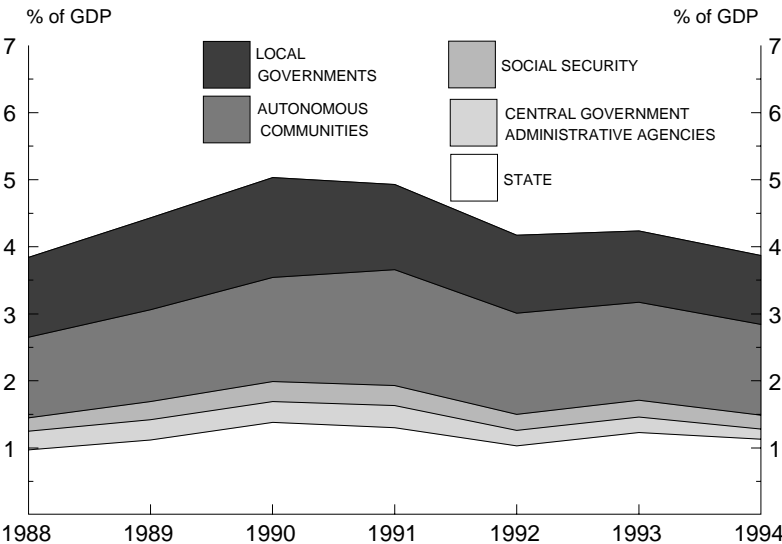


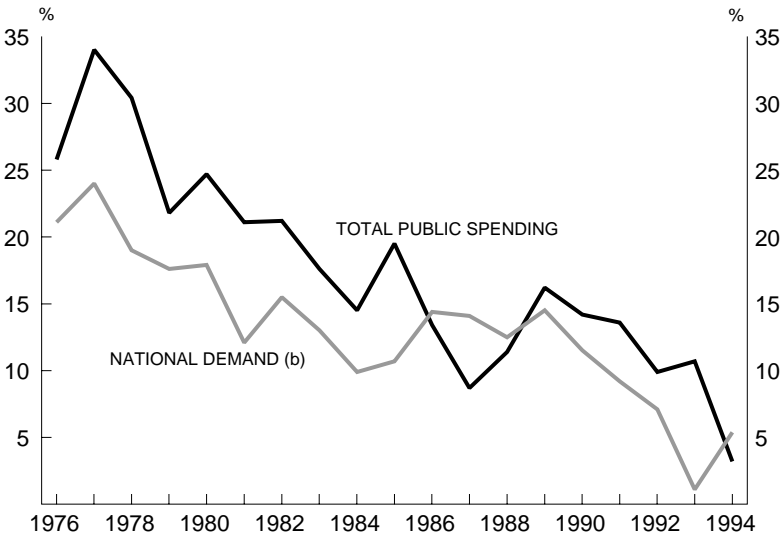


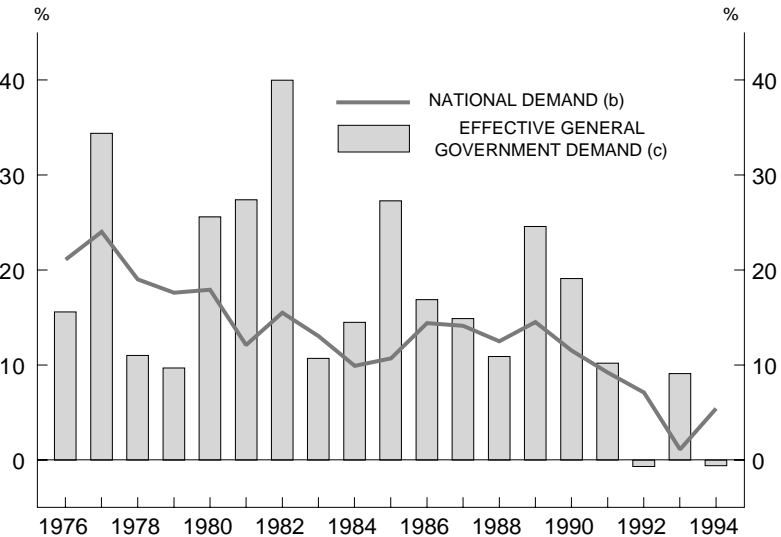


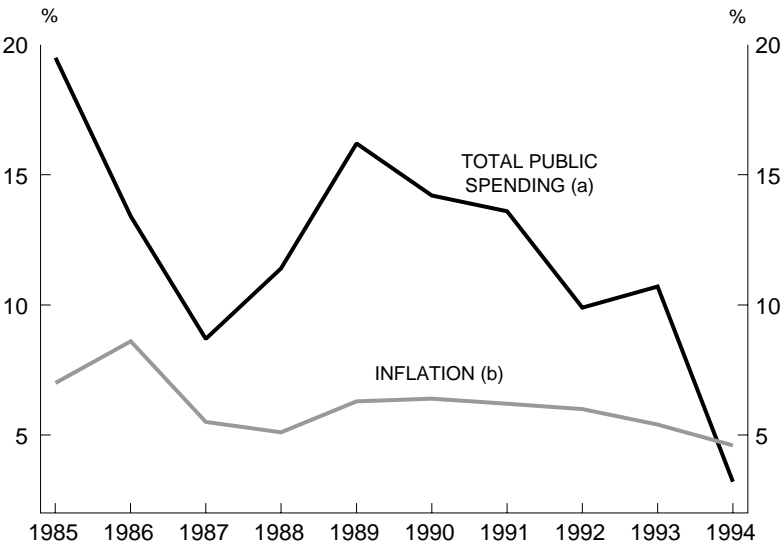


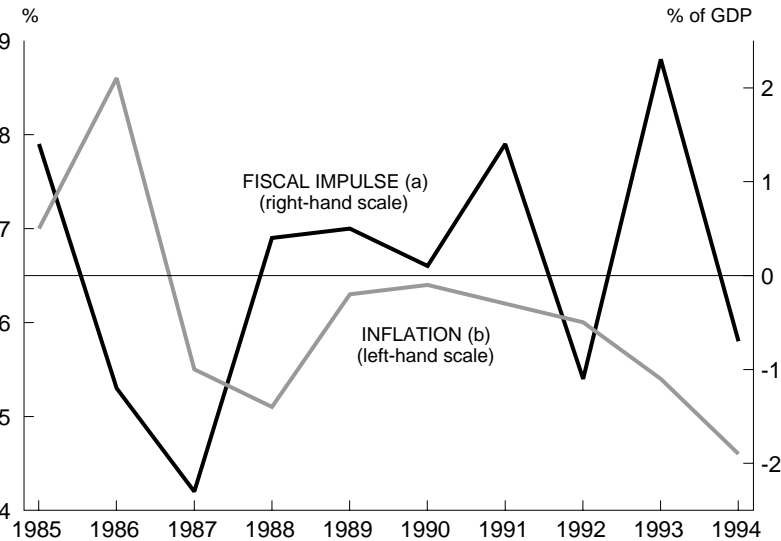


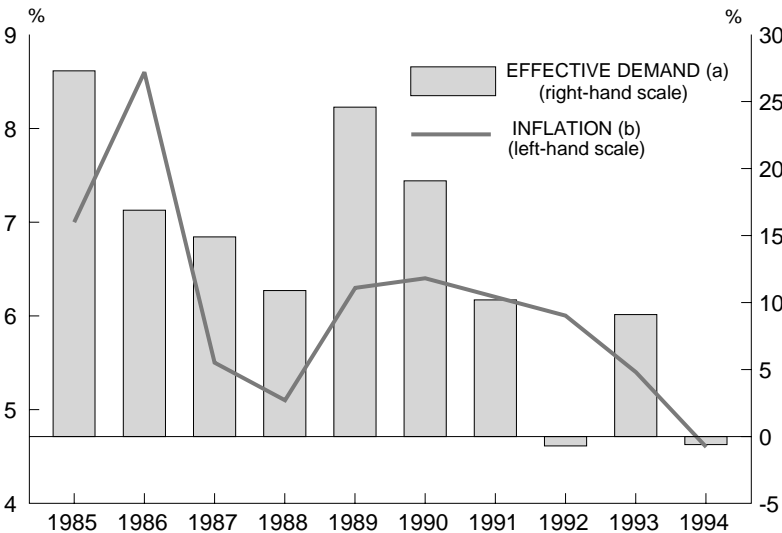




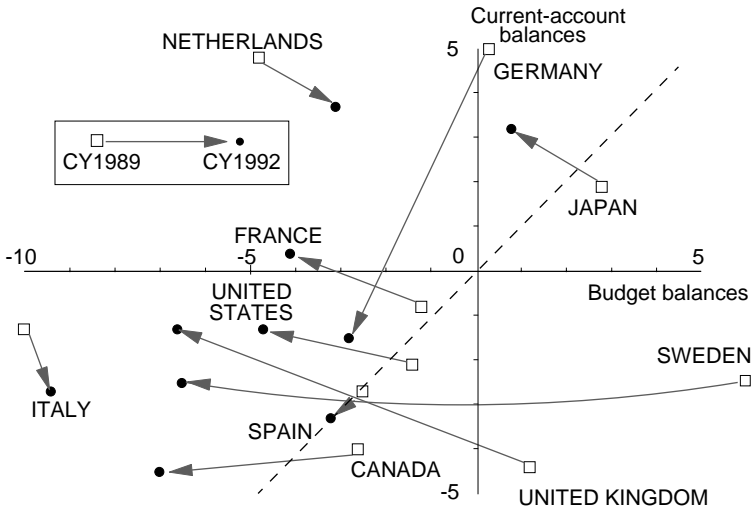


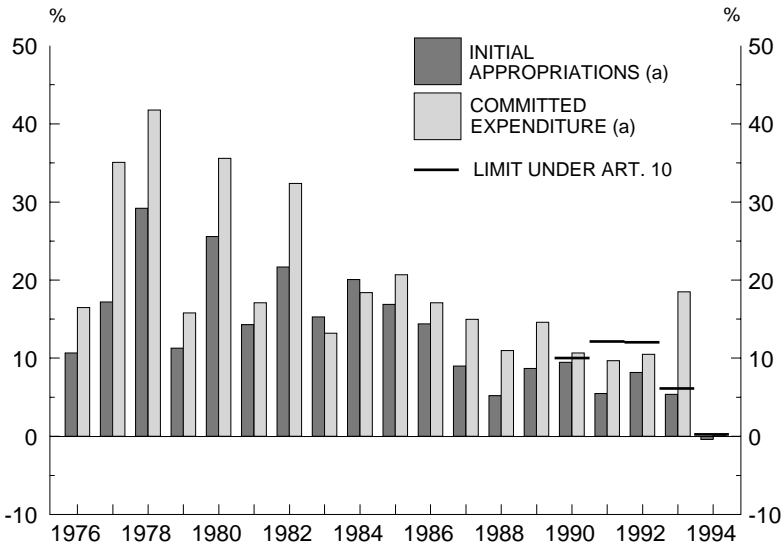


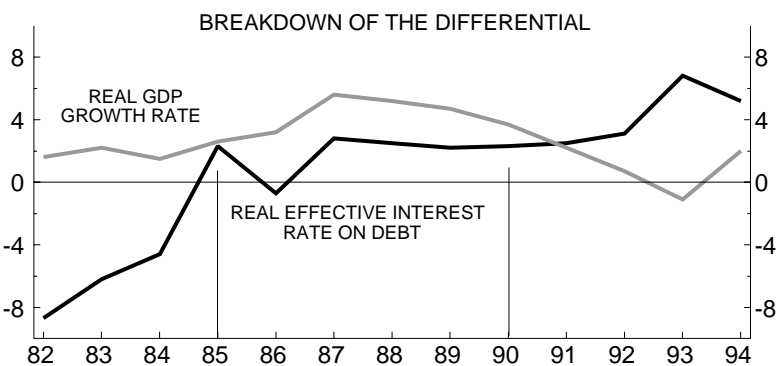
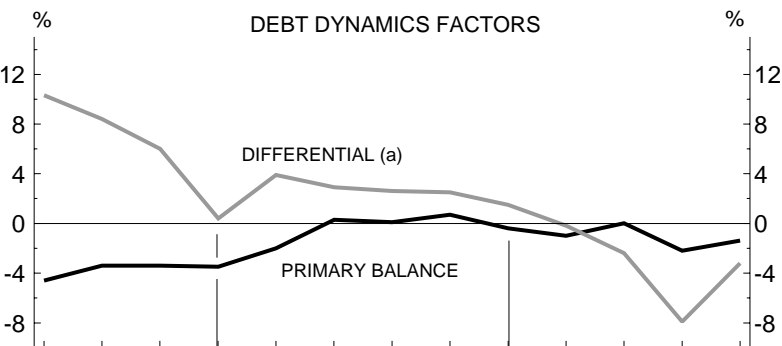
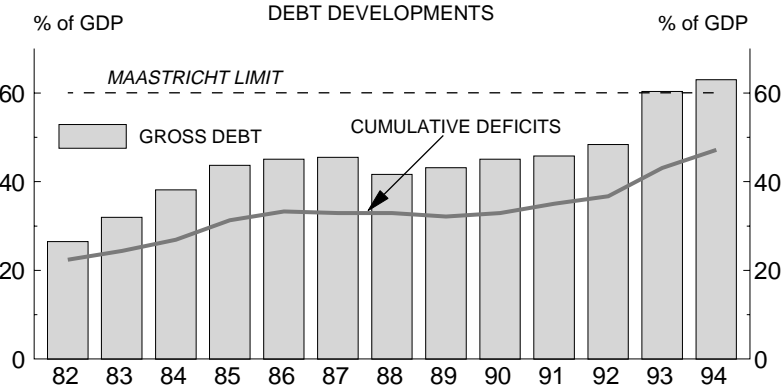


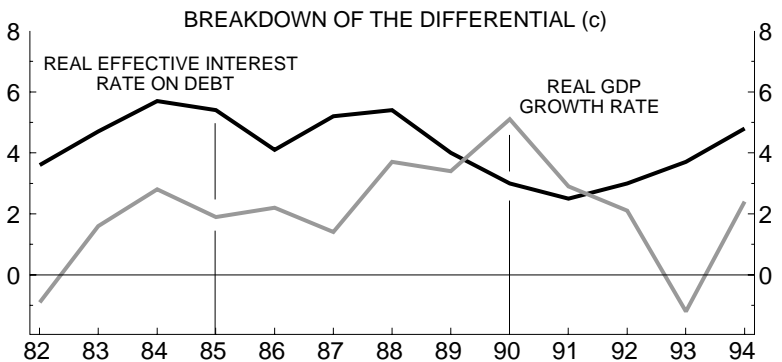
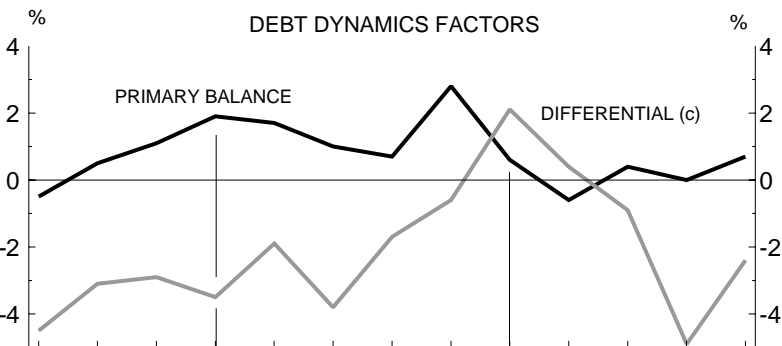
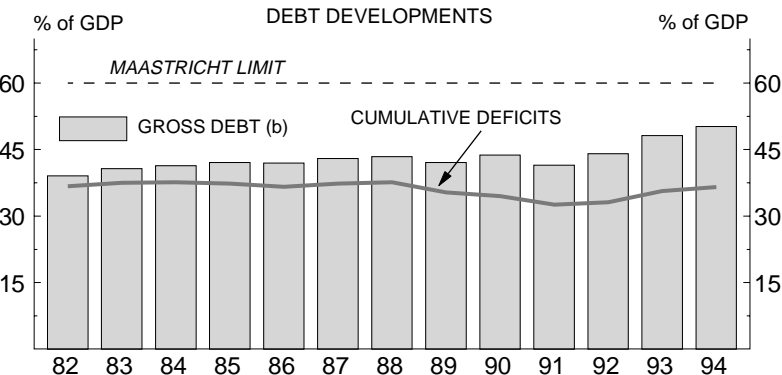


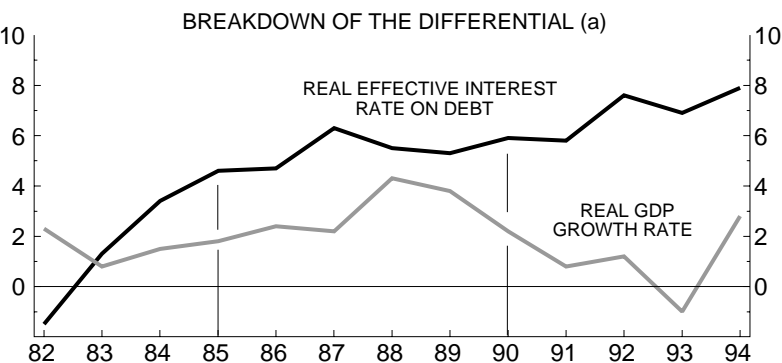
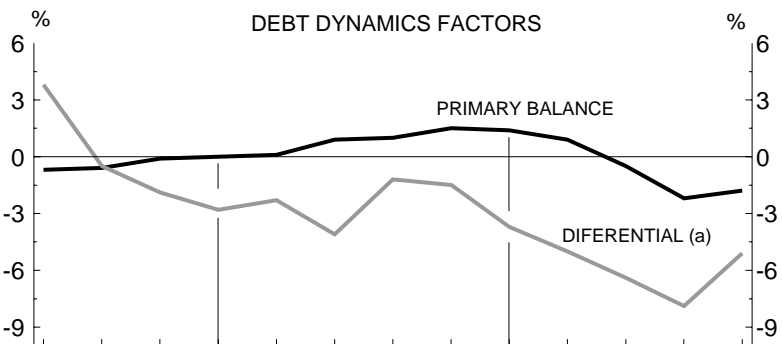
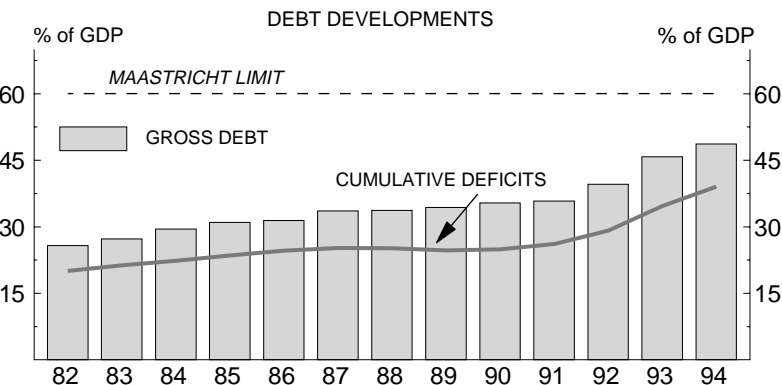
SURPLUS (+) OR DEFICIT (-)
AS % OF NOMINAL GDP

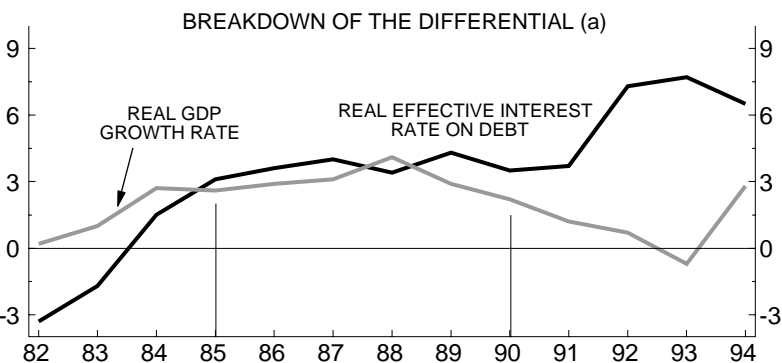
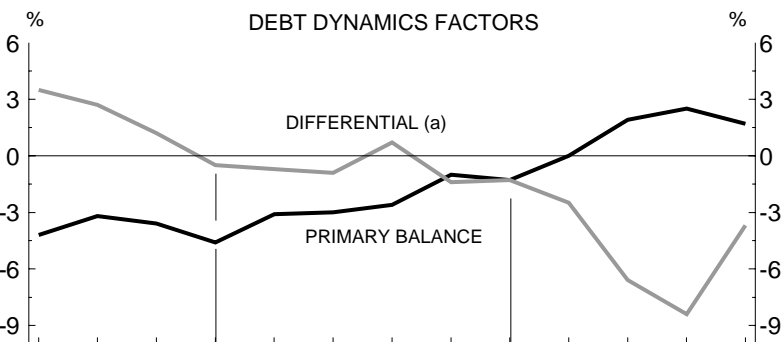
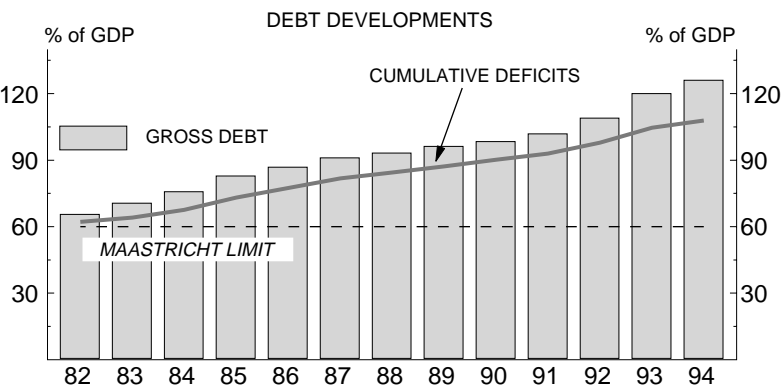




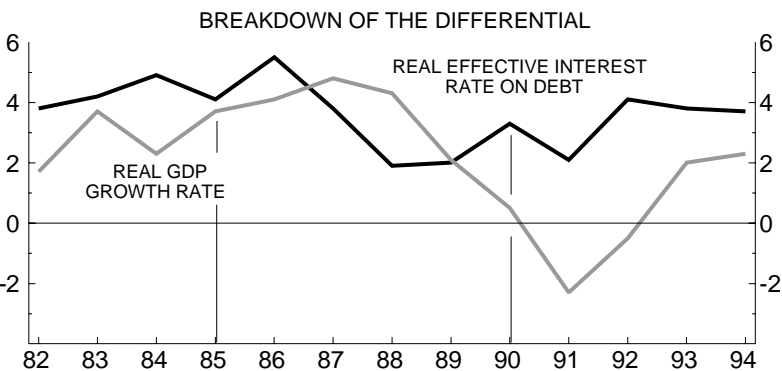
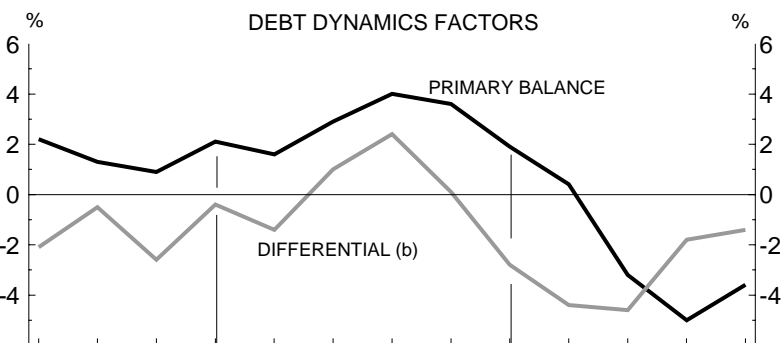
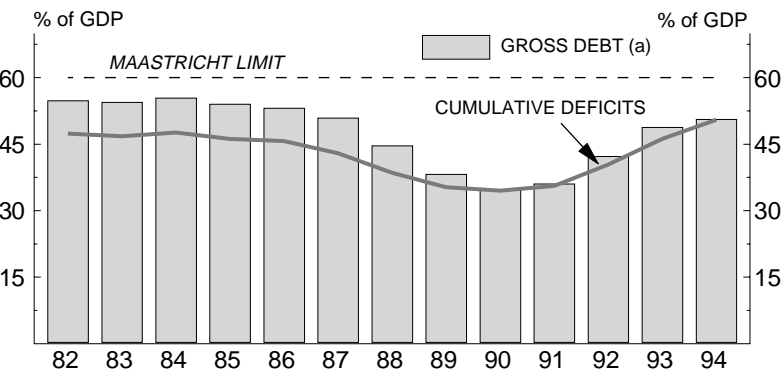




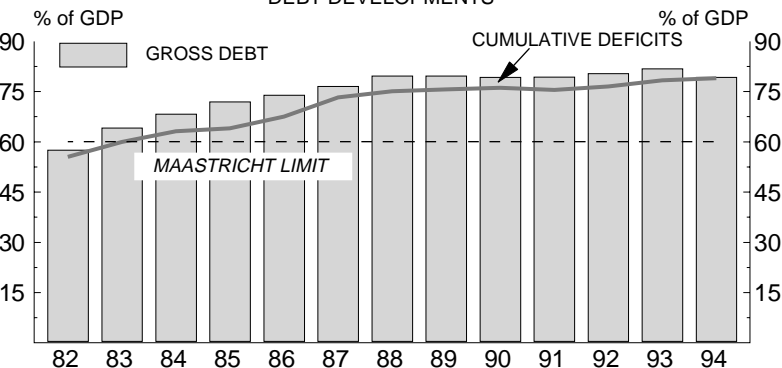




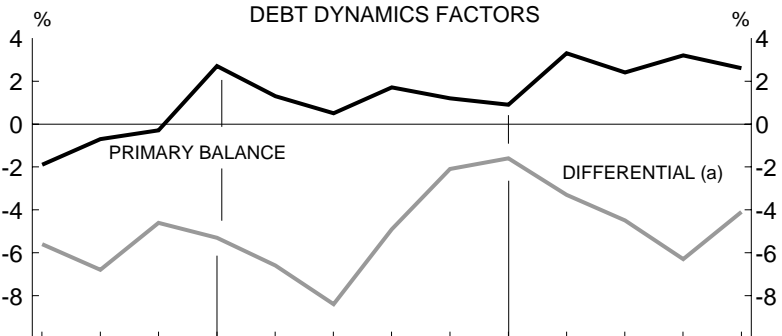
DEBT DEVELOPMENTS



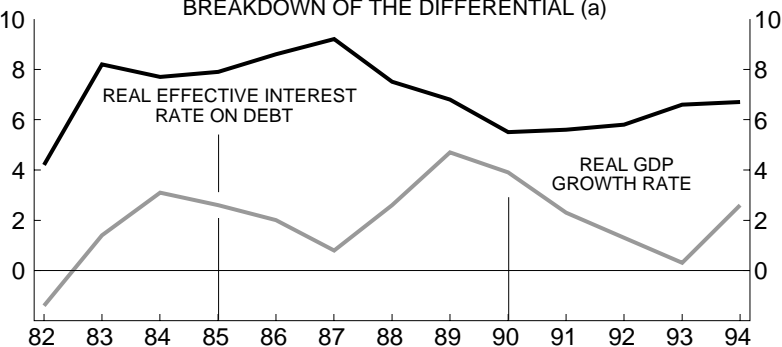
DEBT DEVELOPMENTS



DEBT DYNAMICS FACTORS



BREAKDOWN OF THE DIFFERENTIAL (a)



DEBT DEVELOPMENTS

